Midlothian Council
Tuesday 23 February 2021
Item No 8.9

Treasury Management and Investment Strategy 2021/22 & Prudential Indicators

Report by Gary Fairley, Chief Officer Corporate Solutions

Report for Decision

1 Recommendations

Council is recommended to:-

a) Note that there are no changes proposed to the Treasury Management and Investment Strategy (TMIS) for 2021/22 other than to:-
   i. Reflect the Council's decision to invest in the Energy Services Company (ESCO);
   ii. Update the Prudential Indicators (the three key prudential indicators relating to external borrowing as outlined in Section 4, and the remaining indicators as outlined in Appendix 2), to reflect the revised capital plans; and
   iii. Retain the current approach for the repayment of loans fund advances.

b) Note that a draft of the Treasury Management and Investment Strategy 2021/22 was considered at the Treasury Management Briefing session for all Elected Members and Members of the Audit Committee on Wednesday 17 February 2021, and that the recommended changes arising from that session are reflected in this report;

c) Accordingly approve the Treasury Management and Investment Strategy for 2021/22.

2 Purpose of Report/Executive Summary

The report provides an update on the implementation of the Council's Treasury Management and Investment Strategy 2020/21 (TMIS) and makes recommendations to facilitate consideration of the 2021/22 Strategy, specifically the Treasury Management and Annual Investment Strategies for 2021/22, the Prudential and Treasury indicators contained therein, and the approach to the statutory repayment of loans fund advances.

In recognition of the cancellation of the Audit Committee scheduled to consider a draft of the proposed TMIS for 2021/22, and in accordance with the Decision of Council on 15 December 2020, a Treasury Management Briefing for all Elected Members and Members of the Audit Committee took place on Wednesday 17 February 2021. This briefing session also provided an opportunity for Elected Members and Members of the Audit Committee to scrutinise the draft TMIS in advance of consideration by Council. This final report to Council reflects the changes arising from the Briefing session.

Date: 17 February 2021
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3. Treasury Management & Investment Strategy 2021/22

3.1 Current Loan and Investment Portfolio

The Council's loan and investment portfolio, as at 21 January 2021, is shown in tables 1 and 2 below:-

Table 1: Current Loan Portfolio as at 21 January 2021

Loan Type	Principal Outstanding £000's	Weighted Average Rate
PWLB Annuity	597	8.90%
PWLB Maturity	235,424	3.28%
LOBO	20,000	4.51%
Market Loans	18,369	2.68%
Salix Loans	601	0.00%
Total Loans	**274,991**	**3.34%**

Table 2: Current Investment Portfolio as at 21 January 2021

Investment Type	Principal Outstanding £000's	Weighted Average Rate
Bank Call Accounts	17,687	0.01%
Money Market Funds	29,817	0.01%
Bank Notice Accounts	14,985	0.58%
Other Local Authorities	70,000	1.55%
Total Investments	**132,489**	**0.89%**

Borrowing

The principle source of borrowing is the UK Debt Management Office's Public Works Loans Board (PWLB) and fixed rate loans are taken at a time and tenure which takes cognisance of the PWLB rates (derived from the UK Gilts market) and the management of maturity risk in the long term across the Council's loan portfolio.

The Council is not borrowing from PWLB to onward lend. The TMIS provides for capital investment to be underpinned by long-term borrowing, recognising the extremely low interest rate environment and long term benefits of de risking the delivery and affordability of the capital plans by locking into the certainty brought by PWLB fixed rate loans.

Investments

The Council's deposits as at 21 January 2021 are set out in the Treasury Management & Annual Investment Strategy Statement – 2021/22 Detailed in Appendix 4, Section 4.4 and total £132.489 million. The Council's investment position fluctuates on a daily basis, with the 2020/21 Treasury Management Mid-Year Review Report setting out the position at 31 March 2020 of £111.363 million and six months later on 30 September 2020, at £144.285 million.

The movement is in the money market funds (long term deposits have needed refinanced but remain at £69.985m) which as the report highlighted are used for "day to day liquidity to meet cashflow requirements".

The amount held in instant access accounts (£47.504 million as at 21 January 2021) is reflective of (a) the Scottish Government providing upfront funding to local authorities to support a range of grant schemes; (b) advanced Revenue Support Grant payments and Early Years Capital Grant payments in 2020/21; and (c) the impact of Covid on the Council's cashflow due to rephasing of capital expenditure plans.

3.2 Borrowing Requirement 2020/21 to 2024/25

The Council's capital plans contain projections of capital expenditure and income over the forthcoming financial years. Any expenditure not financed directly by income, requires funding through borrowing.

The projected borrowing requirement arising from the Council's Capital Plans, and the maturing long-term loans that require to be refinanced, over the period 2020/21 to 2024/25 is shown in table 3:-

Table 3: Total Borrowing Requirement over the period 2020/21 to 2024/25

	2020/21 £000's	**2021/22 £000's**	**2022/23 £000's**	**2023/24 £000's**	**2024/25 £000's**	**Total £000's**
Capital Expenditure						
General Services	31,708	36,346	54,661	60,132	41,773	**224,621**
HRA	19,138	107,271	110,779	76,712	28,962	**342,862**
Total Capital Expenditure	**50,846**	**143,617**	**165,440**	**136,844**	**70,735**	**567,483**
Total Available Financing	-18,823	-44,782	-38,689	-31,484	-21,882	**-155,661**
Principal Debt Repayments	-9,123	-9,594	-10,781	-11,870	-12,711	**-54,079**
Capital Expenditure less available Financing	**22,900**	**89,241**	**115,971**	**93,490**	**36,142**	**357,744**
Maturing Long-term Loans	9,282	1,524	1,465	830	1,531	**14,632**
Total Borrowing Requirement	**32,182**	**90,765**	**117,436**	**94,320**	**37,673**	**372,376**
Borrowing secured	-15,000	0	0	0	0	-15,000
Total Remaining Borrowing Requirement	**17,182**	**90,765**	**117,436**	**94,320**	**37,673**	**357,376**

3.3 Main Objectives of TMIS 2021/22

Officers are not proposing any material changes to the current TMIS. The existing strategy that was scrutinised by Audit Committee in January 2020 and approved by Council in February 2020, and the objectives of this, as noted below, is recommended to be rolled forward a year:-

- Secure long-term borrowing to fund capital investment, through locking in to historically low long-term interest rates and de-risking the Council's Capital Financing Requirement;

- To ensure short-term liquidity to manage its day-to-day cashflow. This is achieved through the utilisation of instant access Money Market Fund and Bank Accounts, with the amount held in these reflecting the Council's level of working capital and fluctuating throughout the year due to a number of factors;

- To cash back the Council's usable reserves and seek a safe return on these investments.

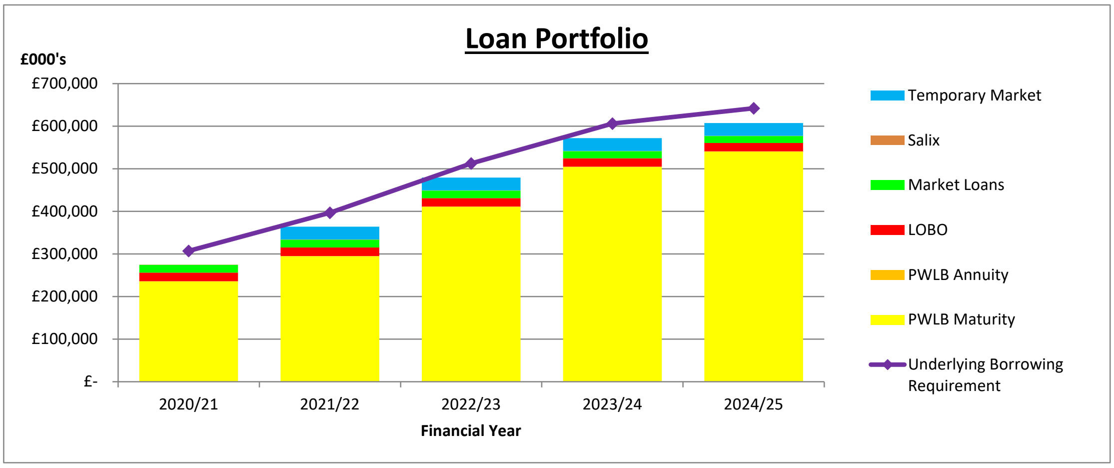
Similarly no changes are recommended to the Permitted Investments other than the formality of including investment in the Midlothian Energy Company (this is a formality as Council has, by agreeing to participate in the Joint Venture Company, accepted that this will be a Permitted Investment).

More detail on the borrowing and investment strategy for 2021/22 is provided in Sections 3.4 and 3.5 below. Section 4 updates the Prudential Indicators based on the latest Capital Plans, and Section 5 proposes no change to the Council's policy for the repayment of loans fund advances from that scrutinised by Audit Committee in January 2020 and approved by Council in February 2020.

3.4 Borrowing Strategy for remainder of 2020/21 and 2021/22

Borrowing is undertaken to finance the Council's approved Capital plans and to do so in the most cost effective way. As can been noted from Table 3 above the Council has a significant borrowing requirement across the forthcoming 4 financial years (2021/22 to 2024/25).

The Council's projected loan portfolio over the period 2020/21 to 2024/25 is shown in graphical format below.



On 26 November 2020, in parallel to Chancellor of the Exchequer Spending Review Announcement, the UK Government's Debt Management Office implemented changes to the PWLB lending rates. PWLB's non-HRA lending rate was cut from its level of gilts + 180 basis points to gilts + 100 basis points. Rates for medium-long term borrowing rates for both HRA and non-HRA purposes are therefore at historically low levels and significantly below historical averages.

At the same time, the current low Bank of England base rate level of 0.10%, and the expectation that there will be no base rate rises in the short-medium term, means that continued utilisation of temporary borrowing within the Council's overall loan portfolio would continue to provide a cost-effective solution to the Council. The quantum of this will continue to be assessed against the backdrop of potential long term costs if the opportunity is missed to take PWLB or other market loans at historically low medium-long term rates, particularly given the projected gradual rise in PWLB rates.

It is expected that the majority of the remaining borrowing requirement to fund capital expenditure incurred in the remainder of 2020/21 and through to 2024/25 shall be sourced from a blend of temporary borrowing and by locking in to longer term PWLB borrowing to manage longer term cost and risk for the loan portfolio. The opportunity also continues to exist to consider further loans on a 'forward dealing' basis, and officers will continue to explore the viability of these loans throughout the remainder of 2020/21 and into 2021/22.

The projected under-borrowing position as at 31 March 2021 is £32.363 million. This means that the Council have funded an equivalent amount of capital expenditure on new assets through internal resources / working capital, and have not committed to fixed long term borrowing to fund this capital expenditure through loans from external counterparties. Other options available to the Council would be to borrow a further £32.363 million from external loan providers to fully finance the capital investment which would result in an additional cost to the revenue budget; or to mature the existing £69.985 million of deposits that are cash backing the Council's reserves and defer equivalent long term borrowing over the current and forthcoming financial years, until the reserves are utilised. Whilst this may result in savings against the Council's current loan charges in the short term it will expose the Council to a significant risk in the medium to long term by having over £100 million exposure to interest rate and refinancing risk.

Council officers have assessed that the current level of the under-borrowed position is a prudent approach which balances (a) the short-medium term cashflow benefit and saving to the revenue budget of using internal resources / working capital at a lower cost against (b) the longer-term risk of not locking into longer-term borrowing at still historically low longer term borrowing rates.

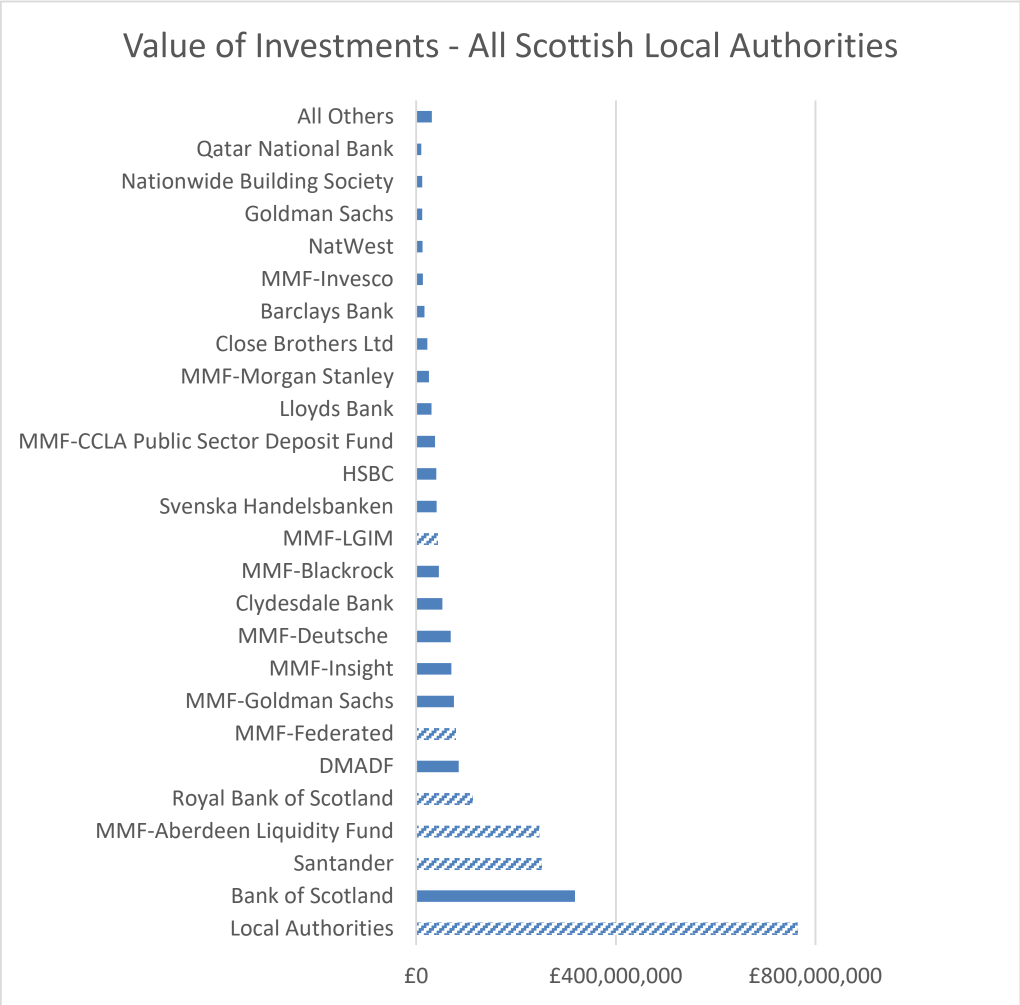
Officers will ensure that any loans taken are drawn to match the existing maturity and projected capital expenditure profiles as closely as possible, that proposed interest rates continue to sit below forward interest rate projections, and that the overall borrowing remains within the Authorised Limit proposed below.

It is expected that, given current market conditions, no borrowing in advance of need for the remainder of 2020/21 and throughout 2021/22 will be undertaken, and that all borrowing undertaken in these periods will be aligned to match as closely as possible to the incurrence of capital expenditure in the remainder of 2020/21 and throughout 2021/22. Should market conditions materially change and which would support any borrowing in advance of need, any borrowing drawn would be supported by a business case which will appraise the anticipated savings in borrowing costs (from expected increases in rates later in the year / in forthcoming years) against the carrying cost associated with borrowing in advance of need.

3.5 Investment Strategy

No changes are proposed to the Investment Strategy other than to reflect the Council's decision to invest in the Energy Services Company (ESCO).

The Council's portfolio of permitted counterparties (other Local Authorities, Santander, Royal Bank of Scotland, Aberdeen MMF, Federated MMF and LGIM MMF) is reflective of the wider Scottish Local Authority position, as noted in the graph below. Counterparties that the Council currently have deposits with are shown as a hatched bar:-



The list of Permitted Investments in Appendix 1 remains unchanged from that approved by Council in the 2020/21 TMIS, other than to be updated to reflect the Council's decision to invest in the ESCO.

4 Prudential Indicators

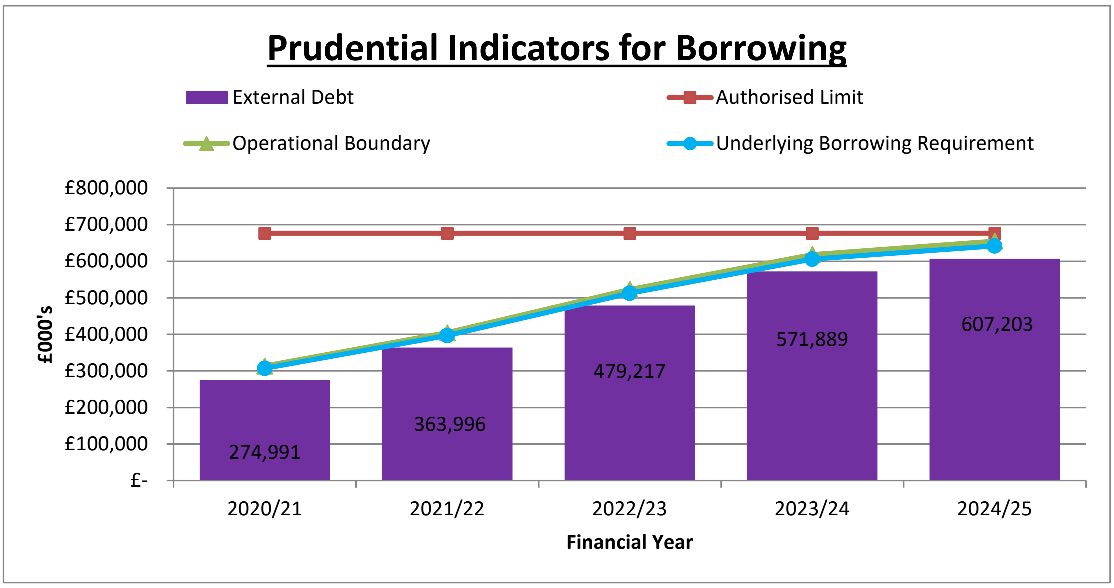
Prudential Code for Capital Finance in Local Authorities

The Prudential Code for Capital Finance in Local Authorities requires that Councils can demonstrate that their Capital Plans are affordable, prudent and sustainable, taking into account the financial provisions made in current and future revenue budgets; and that Treasury Management decisions are taken in accordance with good practice.

The Prudential Indicators that Councils need to consider relate to both actual, historic outcomes, and future estimated outcomes (covering the same period as the Council's Capital Plans), as follows:-

- Actual outcomes for 2019/20;
- Revised estimates of the 2020/21 indicators; and
- Estimates of indicators for 2021/22 to 2024/25.

The Prudential Indicators required by the Code are listed individually in Appendix 2. The key indicators relating to external borrowing are shown in graphical format below.



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

The **Authorised Limit for Borrowing** represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It is the expected maximum borrowing need with some headroom for unexpected movements.

The Authorised Limit for Borrowing has been calculated by taking the maximum value of the CFR over this year and the next 4 financial years (2021/22 to 2024/25), with the total forecast level of capital receipts and developer contributions added back to this figure (given the inherent uncertainty regarding the timing and value of these receipts/contributions). This is shown in table 5 below.

Table 5: Authorised Limit for Borrowing: Calculation

Authorised Limit	**Amount £000's**
CFR – General Services (31 March 2025)	201,194
CFR – HRA (31 March 2025)	441,004
Unrealised Capital Receipts/Developer Contributions 20/21	248
Forecast Capital Receipts & Developer Contributions 21/22-24/25	34,063
Proposed Authorised Limit	**676,508**

Council is therefore asked to approve an adjustment to the authorised limit for borrowing to £676.508 million, if market conditions support this action. This would have the effect of securing lower costs for future years but care would be taken to ensure that the cost of carry from borrowing early is minimised and that the maturity structure of all debt is sufficiently robust to ensure that the CFR at 31 March 2025 remains achievable.

The authorised limit therefore reflects a level of borrowing which, while not desired, could be afforded but is not sustainable.

5 Statutory repayment of loans fund advances

Under the Local Government Finance Circular 7/2016, Council is now required to set out its policy for the statutory repayment of loans fund advances prior to the start of each financial year. The repayment of loans fund advances ensures that the Council makes a prudent provision each year to pay off an element of the accumulated loans fund advances made in previous financial years.

It is proposed to retain the methodology adopted in 2020/21 – that is as follows:-

5.1 New Assets

In accordance with Finance Circular 7/2016, for all advances made in relation to the provision of a new asset, the policy will be to defer the commencement of the first principal repayment of the loans fund advance until the financial year following the one in which the asset is first available for use.

5.2 Prudent Repayment of Loans Fund Advances

Finance Circular 7/2016 provides a variety of options to Councils for the profiling of the repayment of each loans fund advance, so long as the principle of prudence is maintained. There are 4 options available: (a) Asset Life method; (b) Statutory method; (c) Depreciation method; and (d) Funding/income profile method.

In line with the policy adopted in 2020/21, the Asset Life method shall be used for those assets in Table 6.

Table 6: Asset Classes to adopt the "Asset Life" method

Infrastructure	**Current Loans Fund Advance Period***	**Proposed Loans Fund Advance Period**
New Primary Schools/Extensions	50	60
New Leisure Centres	39	60
New Offices	25	60
Road Upgrades	29	50
Street Lighting Columns	26	50
Structures/Bridges	26	50
Footway/Cyclepaths	30	50
Town Centre Environmental Improvements	20	50
New Care Homes	33	45
Children's Play Equipment	9	20

* *Average loans fund advance length*

The annual repayments under the "Asset Life" method for those asset classes as noted above will be calculated using the asset lives and will use the annuity method, to ensure consistency of approach with the Statutory method for all other asset classes (see below). The annuity interest rate that will be used to calculate loans fund principal repayments under the “Asset Life” method will be the in-year loans fund rate, which for 2020/21 is currently estimated to be 2.96%.

For all other asset classes, the policy will be to maintain the practice of previous years and apply what is termed “the Statutory Method” – following the principles of Schedule 3 of the Local Government (Scotland) Act 1975 – with all loans fund advances being repaid by the annuity method. The annuity rate that is proposed to be applied to the loans fund repayments varies will be the in-year loans fund rate, reflecting the Council’s current loan and investment portfolio. The loans fund rate for 2020/21 is forecast to be 3.10%

Whilst neither the Depreciation nor the Funding/income profile methods are currently proposed, Council officers will continue to monitor whether it is appropriate to use this for future capital projects.

6 Performance Indicators 2019/20 – comparison with other Scottish Local Authorities

The Treasury Management Forum collates performance indicators for all Scottish Local Authorities. The indicators relating to financial year 2019/20 have been published and once again demonstrate the continuing effectiveness of the Treasury function in maximising efficiency in Treasury Management activity, with the Council having the 2nd lowest weighted average borrowing & investment (loans fund) rate across all Scottish mainland authorities in 2019/20. The Council has consistently maintained the loans fund rate as one of the lowest across all Scottish mainland authorities for each of the last 10 financial years. Appendix 3 outlines the loans fund rate for each Scottish Local Authority in 2019/20.

Were the internal loans fund rate to have equated to the Scottish weighted average of 3.70%, this would have generated loan charges in 2019/20 of £19.0m. The Council’s actual 2019/20 loan charges for General Services and HRA were £16.8m, representing a cash saving (compared to the Scotland average) of £2.2m in 2019/20.

7. Report Implications

7.1 Resource

There are no direct resource implications arising from this report.

7.2 Digital

None

7.3 Risk

The strategies outlined in this report are designed to maintain the effectiveness of the overall risk management arrangements for Treasury activity. Providing the limits outlined in the strategies are observed they will support the controls already in place in the Treasury Management Practices within which the treasury function operates.

The Prudential Indicators contained in Appendix 2 maintain the effectiveness of the overall risk management of Capital Investment and Treasury Management.

7.4 Ensuring Equalities

There are no equality issues arising from this report.

7.5 Additional Report Implications

See Appendix A.

Appendix A: Report Implications

A.1 Key Priorities within the Single Midlothian Plan

Not applicable.

A.2 Key Drivers for Change

A.3 Key Delivery Streams

Themes addressed in this report:

- ☐ One Council Working with you, for you
- ☒ Preventative and Sustainable
- ☐ Efficient and Modern
- ☐ Innovative and Ambitious
- ☐ None of the above

A.4 Delivering Best Value

The report does not directly impact on Delivering Best Value.

A.5 Involving Communities and Other Stakeholders

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

A.6 Impact on Performance and Outcomes

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

A.7 Adopting a Preventative Approach

Not applicable.

A.8 Supporting Sustainable Development

Not applicable

Background Papers:-

Appendix 1:- Permitted Investments
Appendix 2:- Prudential Indicators
Appendix 3: Performance Indicators 2019/20
Appendix 4:- Treasury Management & Annual Investment Strategy Statement – 2021/22 Detailed

Permitted Investments Appendix 1

The Council uses the Link creditworthiness service for specific categories of permitted investments. This utilises credit ratings from the three main credit rating agencies – Fitch, Moody's and Standard & Poors, along with credit watches, outlooks, CDS spreads and country sovereign ratings in a weighted scoring system with an end product of a series of colour coded bands which indicate the relative creditworthiness of specific categories of counterparties for investment.

These colour codes are used by the Council to determine the maximum suggested duration for investment with that counterparty. These are as follows:-

Link Asset Services Colour Code	**Maximum Suggested Duration for Investment**
Yellow	6 years*
Dark Pink	6 years**
Light Pink	6 years**
Purple	3 years
Blue	2 years***
Orange	2 years
Red	8 months
Green	120 days
No colour	Not to be used

* *Note the yellow colour category is for:- UK Government Debt, or its equivalent, Money Market Funds (MMF's), and collateralised deposits where the collateral is UK Government Debt*

** *Dark Pink for Ultra Short Dated Bond Funds with a credit score of 1.25; Light Pink for Ultra Short Dated Bond Funds with a credit score of 1.5*

*** *Only applies to nationalised or semi-nationalised UK banks*

Note that the maximum suggested durations listed above have been extended by 1 year (when compared to the suggested maximum durations provided by Link) for the Yellow, Dark Pink, Light Pink, Purple, Blue and Orange categories, to allow flexibility around these durations on the margins e.g. the placement of a 13 month fixed term deposit for a counterparty rated Orange or Blue. Equally, the maximum suggested duration for the Red category has been extended by a month to 8 months, and the maximum duration for the Green category has been extended by 20 days to 120 days, on the same basis. A thorough appraisal of the additional risk involved in extending the duration of any deposit (marginally) beyond the maximum suggested by Link, against any enhanced value to the portfolio, will be undertaken prior to the placement of any deposit.

1.1 Deposits

Investment Category	Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period
Debt Management Agency Deposit Facility	--	Term	No	**100%**	**6 months**
Term deposits – local authorities	--	Term	No	**100%**	**5 years**
Call accounts – banks and building societies	Green	Instant	No	**100%**	**1 day**
Term deposits / Notice Accounts – banks and building societies	Yellow Purple Blue Orange Red Green No Colour	Term	No	**100%**	**Up to 6 yrs Up to 3 yrs Up to 2 yrs Up to 2 yrs Up to 8 mths Up to 120 days Not for use**
Fixed term deposits with variable rate and variable maturities: - Structured deposits	Yellow Purple Blue Orange Red Green No Colour	Term	No	**100%**	**Up to 6 yrs Up to 3 yrs Up to 2 yrs Up to 2 yrs Up to 8 mths Up to 120 days Not for use**

1.2 Deposits with counterparties currently in receipt of government support / ownership

Investment Category	Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period
UK nationalised banks – Call accounts	Blue	Instant	No	**100%**	**1 day**
UK nationalised banks – Term Deposits / Notice Accounts	Blue	Term	No	**100%**	**2 years**
UK nationalised banks – Fixed term deposits with variable rate and variable maturities: - Structured deposits	Blue	Term	No	**100%**	**2 years**
Non-UK(high sovereign rated country) nationalised banks – Call accounts	Green	Instant	No	**100%**	**1 day**
Non-UK (high sovereign rated country) nationalised banks:- Term Deposits / Notice Accounts	Yellow Purple Blue Orange Red Green No Colour	Term	No	**100%**	**Up to 6 yrs Up to 3 yrs Up to 2 yrs Up to 2 yrs Up to 8 mths Up to 120 days Not for use**
Non-UK (high sovereign rated country) nationalised banks:- Fixed term deposits with variable rate and variable maturities: - Structured deposits	Yellow Purple Blue Orange Red Green No Colour	Term	No	**100%**	**Up to 6 yrs Up to 3 yrs Up to 2 yrs Up to 2 yrs Up to 8 mths Up to 120 days Not for use**

If forward deposits are made, the forward period plus the deal period equate to the maximum maturity period.

1.3 Collective investment schemes structured as Open Ended Investment Companies (OEICs)

Investment Category	Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period
Government Liquidity Funds	AAA	Instant	No	**100%**	**1 day**
Money Market Funds CNAV	AAA	Instant	No	**100%**	**1 day**
Money Market Funds LVNAV	AAA	Instant	No	**100%**	**1 day**
Money Market Funds VNAV	AAA	Instant	No	**100%**	**1 day**
Ultra Short Dated Bond Funds with a credit score of 1.25	AAA	T+1 to T+5	Yes	**100%**	**5 days**
Ultra Short Dated Bond Funds with a credit score of 1.5	AAA	T+1 to T+5	Yes	**100%**	**1 week**
Bond Funds	AAA	T+2 or longer	Yes	**50%**	**2 days**
Gilt Funds	AAA	T+2 or longer	Yes	**50%**	**2 days**

1.4 Securities issued or guaranteed by governments

Investment Category	* Minimum Credit Criteria	Liquidity risk	Market risk	Max %?£m of total investments	Max. maturity period
Treasury Bills	UK sovereign rating	Sale T+1	Yes	**100%**	**50 years**
UK Government Gilts	UK sovereign rating	Sale T+1	Yes	**100%**	**50 years**
Bond issuance issued by a financial institution which is explicitly guaranteed by the UK Government e.g. National Rail	UK sovereign rating	Sale T+3	Yes	**100%**	**50 years**
Sovereign bond issues (other than the UK govt)	AAA (or state your criteria if different)	Sale T+1	Yes	**100%**	**50 years**
Bonds issued by multilateral development banks	AAA (or state your criteria if different)	Sale T+1	Yes	**100%**	**50 years**

1.5 Securities issued by corporate organisations

Investment Category	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Certificates of deposit issued by banks and building societies	Yellow Purple Blue Orange Red Green No Colour	Sale T+0	Yes	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 8 mths** **Up to 100 days** **Not for use**
Commercial paper other	Yellow Purple Blue Orange Red Green No Colour	Sale T+0	Yes	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 8 mths** **Up to 100 days** **Not for use**
Floating rate notes	Yellow Purple Blue Orange Red Green No Colour	Sale T+2	Yes	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 8 mths** **Up to 100 days** **Not for use**
Corporate Bonds other	Yellow Purple Blue Orange Red Green No Colour	Sale T+2	Yes	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 8 mths** **Up to 100 days** **Not for use**

1.6 Other

Investment Category	Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period
Local authority mortgage guarantee scheme.	Blue	Term	No	**50%**	**5 years**
Loans to Third Parties	n/a	Term	No	**£25m**	**25 years**
Subordinated Debt Subscription to Newbattle Centre SPV	n/a	Term	No	**£0.333m**	**25 years**
Property Funds	n/a	T+4	Yes	**50%**	**15 years**
ESCO	n/a	Term	No	**£9m**	**n/a**

Treasury Risks and Mitigating Controls for each type of investment are as outlined in the Treasury Management & Annual Investment Strategy Statement – 2021/22 Detailed – Appendix 5.3.

Prudential Indicators Appendix 2

1. Prudential Indicators for Affordability

These indicators provide an indication of the impact of the capital investment plans on the Council's overall finances.

1.1 Estimates of Ratio of Financing Costs to 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.

Ratio of Financing Costs to Net Revenue Stream						
%	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
General Services	2.69%	2.66%	2.67%	2.82%	2.96%	3.09%
HRA	35.43%	38.48%	37.90%	41.53%	43.20%	44.56%

The figures above are based on the current General Services and HRA Capital Plans.

1.2 HRA Ratios

The following indicator identifies the ratio of overall debt on the HRA account compared to annual house rent revenue.

HRA Debt as a % of Gross Revenue						
	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
HRA debt £000's	£ 171,389	£ 181,436	£ 260,020	£ 352,270	£ 420,862	£ 441,004
HRA revenues £000's	£ 29,283	£ 30,299	£ 32,985	£ 34,692	£ 37,381	£ 38,467
Ratio of debt to revenues %	585%	599%	788%	1015%	1126%	1146%

The following indicator identifies the ratio of overall debt on the HRA account per HRA dwelling.

HRA Debt per Dwelling						
	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
HRA debt £000's	£ 171,389	£ 181,436	£ 260,020	£ 352,270	£ 420,862	£ 441,004
Number of HRA dwellings	6,989	7,060	7,402	8,010	8,522	8,756
Debt per dwelling £	£ 24,523	£ 25,699	£ 35,128	£ 43,979	£ 49,385	£ 50,366

2. Prudential Indicators for Capital Expenditure

The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans is reflected in the prudential indicators, which are designed to assist members' overview and confirm capital expenditure plans.

2.1 Estimated Capital Expenditure

This indicator shows the gross capital spend included in the relevant capital plans.

Capital Expenditure	2019/20 Actual £000's	2020/21 Estimate £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's
General Services						
Place	£ 8,155	£ 17,303	£ 22,174	£ 18,498	£ 15,266	£ 12,189
People & Partnerships	£ 24,249	£ 15,149	£ 14,199	£ 36,205	£ 38,685	£ 18,332
Council Transformation	£ 695	£ 83	£ 766	£ 867	£ 7,548	£ 12,755
Provision for Return of Contingencies	£ -	£ (828)	£ (793)	£ (909)	£ (1,367)	£ (1,503)
Total General Services	**£ 33,099**	**£ 31,708**	**£ 36,346**	**£ 54,661**	**£ 60,132**	**£ 41,773**
Total HRA	**£ 24,936**	**£ 19,138**	**£ 107,271**	**£ 110,779**	**£ 76,712**	**£ 28,962**
Combined Total	**£ 58,035**	**£ 50,846**	**£ 143,617**	**£ 165,440**	**£ 136,844**	**£ 70,735**

2.2 Financing of Capital Expenditure

This indicator shows how the Capital Expenditure forecasts are being financed by capital or revenue resources. Any shortfall of resources results in a funding borrowing need.

Capital Expenditure and Available Financing	2019/20 Actual £000's	2020/21 Estimate £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's
Capital Expenditure						
General Services	£ 33,099	£ 31,708	£ 36,346	£ 54,661	£ 60,132	£ 41,773
HRA	£ 24,936	£ 19,138	£ 107,271	£ 110,779	£ 76,712	£ 28,962
Total	**£ 58,035**	**£ 50,846**	**£ 143,617**	**£ 165,440**	**£ 136,844**	**£ 70,735**
Financed by:						
Capital receipts	£ 315	£ 95	£ 1,020	£ -	£ -	£ -
Capital grants	£ 25,214	£ 14,759	£ 20,475	£ 23,856	£ 17,906	£ 10,073
Capital reserves	£ -	£ -	£ 18,000	£ 3,000	£ 2,000	£ 7,694
Developer/Other Contributions	£ 14,606	£ 3,969	£ 5,287	£ 11,833	£ 11,578	£ 4,115
Net financing need for the year	**£ 17,900**	**£ 32,023**	**£ 98,835**	**£ 126,752**	**£ 105,360**	**£ 48,853**

2.3 Estimated Capital Financing Requirement

This indicator measures the Council's maximum underlying need to borrow for capital purposes and other long term liabilities over the next three years.

Capital Financing Requirement (CFR)						
	2019/20 Actual £000's	2020/21 Estimate £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's
Capital Financing Requirement						
CFR – General Services	£ 113,065	£ 125,918	£ 136,576	£ 160,296	£ 185,194	£ 201,194
CFR – HRA	£ 171,389	£ 181,436	£ 260,020	£ 352,270	£ 420,862	£ 441,004
CFR – PFI Schemes	£ 109,748	£ 99,768	£ 96,433	£ 92,901	£ 89,157	£ 85,189
Total CFR	**£ 394,202**	**£ 407,122**	**£ 493,029**	**£ 605,467**	**£ 695,213**	**£ 727,387**
Movement in CFR	**£ 34,450**	**£ 12,920**	**£ 85,906**	**£ 112,439**	**£ 89,746**	**£ 32,174**
Movement in CFR represented by						
Net financing need for the year (previous table)	£ 17,900	£ 32,023	£ 98,835	£ 126,752	£ 105,360	£ 48,853
Less Scheduled Debt Amortisation	£ (8,063)	£ (9,123)	£ (9,594)	£ (10,781)	£ (11,870)	£ (12,711)
Less net PFI Finance Lease Principal Payments	£ 24,613	£ (9,980)	£ (3,335)	£ (3,532)	£ (3,744)	£ (3,968)
Movement in CFR	**£ 34,450**	**£ 12,920**	**£ 85,906**	**£ 112,439**	**£ 89,746**	**£ 32,174**

3. Prudential Indicators for Prudence

3.1 Net Borrowing Requirement

This indicator shows the amount of external borrowing required to finance the current debt outstanding on capital projects.

Net Borrowing Requirement						
	2019/20 Actual £000's	2020/21 Estimate £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's
External Debt						
Debt at 1 April	£ 237,278	£ 269,077	£ 274,991	£ 363,996	£ 479,217	£ 571,889
Actual/Expected change in Debt	£ 31,799	£ 5,914	£ 89,005	£ 115,221	£ 92,672	£ 35,314
Other long-term liabilities (OLTL)	£ 85,135	£ 109,748	£ 99,768	£ 96,433	£ 92,901	£ 89,157
Actual/Expected change in OLTL	£ 24,613	£ (9,980)	£ (3,335)	£ (3,532)	£ (3,744)	£ (3,968)
Actual/Expected Gross Debt at 31 March	**£ 378,825**	**£ 374,759**	**£ 460,429**	**£ 572,118**	**£ 661,046**	**£ 692,392**
The Capital Financing Requirement	**£ 394,202**	**£ 407,122**	**£ 493,029**	**£ 605,467**	**£ 695,213**	**£ 727,387**
Under / (over) borrowing	**£ 15,377**	**£ 32,363**	**£ 32,599**	**£ 33,349**	**£ 34,167**	**£ 34,995**
Investments						
Cash & Cash Equivalents	£ 26,378	£ 35,000	£ 10,000	£ 10,000	£ 10,000	£ 10,000
Short-Term Investments	£ 84,985	£ 84,985	£ 84,985	£ 69,985	£ 69,985	£ 59,985
Total Investments	**£ 111,363**	**£ 119,985**	**£ 94,985**	**£ 79,985**	**£ 79,985**	**£ 69,985**

4. Prudential Indicators for External Debt

4.1 Operational Boundary

This is the limit beyond which external debt is not normally expected to exceed and will be the focus of day to day treasury management. Typically, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt.

For this Council:-

- the Operational Boundary for Borrowing has been calculated to equate directly to the value of the CFR for General Services and HRA combined, over the current financial year and the following 4 financial years (2020/21 to 2024/25); and
- the Operational Boundary for Other Long-Term Liabilities has been calculated to equate directly to the in-year CFR for Other Long-Term Liabilities, given the known contractual provisions for the repayment of debt within the Council's two PPP agreements.

Operational Boundary					
	2020/21 Estimate £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's
Operational Boundary - Borrowing	£ 307,354	£ 396,596	£ 512,566	£ 606,056	£ 642,198
Operational Boundary - Other long term liabilities	£ 99,768	£ 96,433	£ 92,901	£ 89,157	£ 85,189
Total	**£ 407,122**	**£ 493,029**	**£ 605,467**	**£ 695,213**	**£ 727,387**

Should the Operational Boundary be breached, for example as a result of a decision taken to borrow in advance (should market conditions indicate that it is prudent to do so), this will be reported to Council at the next available opportunity.

4.2 Authorised Limit of Total External Debt

This indicator sets the limit for total external debt.

In an active Treasury Management policy it is sometimes prudent to borrow in advance of need if interest rates are expected to rise.

In order to continue to service the ongoing external debt and finance the current capital programmes the Council needs to increase its external borrowing to £631.481 million by 31 March 2024. Within the Capital Plans, there are assumptions regarding capital receipts and developer contributions which when applied to the Council's capital plans reduce the Council's borrowing requirements. However, the realisation of these capital receipts and developer contributions carry inherent uncertainty around both the timing and value of each receipt/contribution, given that they are largely dependent upon economic and market activity which are outwith the Council's control. Therefore, in order to calculate the Authorised Limit for Borrowing, these capital receipts and developer contributions have been added to the Capital Financing Requirement, to give the Council flexibility to fully borrow in advance of need (if market conditions support this action) should these receipts and contributions be unable to be realised in the short term. This therefore reflects a level of borrowing which, while not desired, could be afforded but is not sustainable.

It is expected that, given current market conditions, no borrowing in advance of need for the remainder of 2020/21 and throughout 2021/22 will be undertaken, and that all borrowing undertaken in these periods will be aligned to match as closely as possible to the incurrence of capital expenditure in the remainder of 2020/21 and throughout 2021/22. Should market conditions materially change and which would support any borrowing in advance of need, any borrowing drawn would be supported by a business case which will appraise the anticipated savings in borrowing costs (from expected increases in rates later in the year / in forthcoming years) against the carrying cost associated with borrowing in advance of need.

Council is therefore asked to approve that, rather than restrict borrowing to £307.354 million for 2020/21, £396.596 million for 2021/22, £512.566 million for 2022/23, £606.056 million for 2023/24, and £642.198 million for 2024/25, that permission be granted to borrow up to the 2024/25 Authorised Limit for Borrowing of £676.508 million as shown in the table below), if market conditions support this action.

Adopting this approach will secure lower costs for future years but care will be taken to ensure that the cost of carry is minimised and that the maturity structure of all debt is sufficiently robust to ensure that the Capital Financing Requirement at 31 March 2025 remains achievable.

Authorised Limit					
	2020/21 Estimate £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's
Authorised Limit - Borrowing	£ 676,508	£ 676,508	£ 676,508	£ 676,508	£ 676,508
Authorised Limit - Other long term liabilities	£ 99,768	£ 96,433	£ 92,901	£ 89,157	£ 85,189
Total Debt	**£ 776,276**	**£ 772,941**	**£ 769,409**	**£ 765,665**	**£ 761,697**

Reconciliation of calculation of Authorised Limit for borrowing:-

Reconciliation of Authorised Limit for Borrowing	
	£000's
CFR - General Services at 31 March 2025	£ 201,194
CFR - HRA at 31 March 2025	£ 441,004
Capital Receipts 2020/21 unrealised to date	£ 95
Capital Receipts 2021/22 to 2024/25	£ 1,250
Developer/Other Contributions 2020/21 Unrealised to date	£ 153
Developer/Other Contributions 2021/22 to 2024/25	£ 32,813
Authorised Limit for Borrowing	**£ 676,508**

5. Prudential Indicators for Treasury Management

5.1 Upper limits on Fixed and Variable Interest Rates

This indicator limits the amount of external debt that may be held at fixed or variable rates. These limits are proposed to be as follows:-

Upper Limits on Exposure to Fixed and Variable Interest Rates 2021/22	
Interest rate exposures	**Upper Limit**
Limits on fixed interest rates based on gross debt	100.00%
Limits on variable interest rates based on gross debt	30.00%
Limits on fixed interest rates based on investments	100.00%
Limits on variable interest rates based on investments	100.00%

5.2 Maturity Structure of Borrowing

This indicator sets the upper and lower limits of the time scales within which external debt may be held.

The Treasury Management Code of Practice now requires that LOBO's with a call date in the next 12 months are classified as short-term borrowing rather than longer-term (10 year+) borrowing.

In addition, the Code also recommends that where an authority's debt is typically very long term (i.e. for a period of greater than 10 years), that authorities should break down the period in excess of 10 years into several ranges, for example 10 to 20 years, 20 to 30 years, etc.

With the above in mind, the proposed upper and lower limits for each maturity band are shown below, with the overall aim to ensure a spreading approach to avoid a cluster of high value loans maturing/requiring refinancing within a short period of time.

Maturity Structure of Borrowing 2021/22		
Maturity structure of fixed interest rate borrowing 2021/22	**Lower**	**Upper**
Under 12 months	0.00%	50.00%
12 months to 2 years	0.00%	50.00%
2 years to 5 years	0.00%	50.00%
5 years to 10 years	0.00%	50.00%
10 years to 20 years	0.00%	50.00%
20 years to 30 years	0.00%	50.00%
30 years to 40 years	0.00%	50.00%
40 years to 50 years	0.00%	50.00%
50 years and above	0.00%	50.00%
Maturity structure of variable interest rate borrowing 2021/22	**Lower**	**Upper**
Under 12 months	0.00%	30.00%
12 months to 2 years	0.00%	30.00%
2 years to 5 years	0.00%	30.00%
5 years to 10 years	0.00%	30.00%
10 years to 20 years	0.00%	30.00%
20 years to 30 years	0.00%	30.00%
30 years to 40 years	0.00%	30.00%
40 years to 50 years	0.00%	30.00%
50 years and above	0.00%	30.00%

5.4 Total Principal Sums Invested for Periods Longer than 365 Days

This indicator relates to the total level of investments held for periods longer than 365 days.

Principal Sums Invested for > 365 Days		
Limit		£70m

The current strategy as outlined in the body of these reports is to continue to cash-back the Council's balance sheet reserves. It is expected that the majority of this will be in the form of fixed term deposits and/or certificates of deposit. Given expected reserve forecasts, in particular the short-medium term forecast for the Council's Capital Fund and HRA Reserve, the limit for prinicipal sums invested for > 365 days has been retained at £70m.

For its cash flow generated balances, the Council will seek to utilise its business reserve instant access accounts and money market funds.

Appendix 3: Loans Fund Rate Comparison 2019/20

Authority	Loans Fund Rate
West Dunbartonshire	2.58%
Midlothian	2.95%
Aberdeenshire	3.00%
Perth & Kinross	3.07%
Dumfries & Galloway	3.16%
East Lothian	3.18%
North Lanarkshire	3.45%
Inverclyde	3.50%
Dundee City	3.57%
Argyll & Bute	3.57%
Aberdeen City	3.58%
East Renfrewshire	3.72%
Falkirk	3.77%
East Ayrshire	3.80%
Glasgow City	3.87%
West Lothian	3.87%
Highland	3.89%
Renfrewshire	3.93%
South Ayrshire	3.94%
South Lanarkshire	3.96%
Scottish Borders	4.05%
North Ayrshire	4.06%
East Dunbartonshire	4.06%
Stirling	4.16%
Moray	4.19%
Edinburgh City	4.37%
Angus	4.42%
Clackmannanshire	5.10%

Appendix 4

Treasury Management Strategy Statement
and Annual Investment Strategy

Midlothian Council
2021/22

INDEX

1 INTRODUCTION

1.1 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 or instruments 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 term loans, or using longer term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

The contribution the treasury management function makes to the authority is critical, as the balance of debt and investment operations ensure liquidity or the ability to meet spending commitments as they fall due, either on day-to-day revenue or for larger capital projects. The treasury operations will see a balance of the interest costs of debt and the investment income arising from cash deposits affecting the available budget. Since cash balances generally result from reserves and balances, it is paramount to ensure adequate security of the sums invested, as a loss of principal will in effect result in a loss to the General Fund Balance.

Whilst any loans to third parties, commercial investment initiatives or other non-financial investments will impact on the treasury function, these activities are generally classed as non-treasury activities, (arising usually from capital expenditure),and are separate from the day to day treasury management activities.

CIPFA defines treasury management as:

> *"The management of the local authority's borrowing, 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."*

Revised reporting is required for the 2021/22 reporting cycle due to revisions of the CIPFA Prudential Code and the CIPFA Treasury Management Code. The primary reporting changes include the introduction of a capital strategy, to provide a longer-term focus to the capital plans, and greater reporting requirements surrounding any commercial activity if that is going to be undertaken.

1.2 Reporting requirements

1.2.1 Capital Strategy

The CIPFA revised 2017 Prudential and Treasury Management Codes require, from 2019-20, all local authorities to prepare an additional report, a capital strategy report, which provides the following:

- a high-level long term overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services
- an overview of how the associated risk is managed
- the implications for future financial sustainability

The aim of this capital strategy is to ensure that all elected members on the full council fully understand the overall long-term policy objectives and resulting capital strategy requirements, governance procedures and risk appetite.

1.2.2 Treasury Management Reporting

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

a) **Prudential and treasury indicators and treasury strategy** (this report) - The first, and most important report covers:
   - the capital plans (including prudential indicators) for 2020/21 to 2024/25;
   - a policy for the statutory repayment of debt, (how residual capital expenditure is charged to revenue over time);
   - the treasury management strategy (how the investments and borrowings are to be organised) for 2021/22, including treasury indicators; and
   - a permitted investment strategy for 2021/22 (the parameters on how investments are to be managed).

b) **A mid year treasury management report** – This will update members with the progress of the capital position, amending prudential indicators as necessary, and whether the actual treasury strategy is meeting the strategy outlined in advance of the year, or whether any policies require revision.

c) **An annual treasury outturn report** – This provides details of a selection of actual prudential and treasury indicators for the previous financial year and actual treasury operations compared to the estimates within the strategy.

Scrutiny
The above reports are required to be adequately scrutinised before being recommended to the Council. This role is normally undertaken by the Audit Committee with this report being presented to Audit Committee prior to consideration by Council. A Treasury Management Briefing session for all Elected Members and Members of the Audit Committee took place on 17 February 2021. The briefing session provided an opportunity for Elected Members and Members of the Audit Committee to scrutinise the draft TMIS in advance of consideration by Council. This final report to Council reflects the recommended changes arising from this Briefing session.

For the TMSS 2021/22, there are no material changes to the current TMIS. The existing strategy that was scrutinised by Audit Committee in January 2020 and the objectives of the existing strategy, as noted below, are recommended to be rolled forward a year,

- Secure long-term borrowing to fund capital investment, through locking in to historically low long-term interest rates and de-risking the Council's Capital Financing Requirement;
- To ensure short-term liquidity to manage its day-to-day cashflow. This is achieved through the utilisation of instant access Money Market Fund and Bank Accounts, with the amount held in these reflecting the Council's level of working capital and fluctuating throughout the year due to a number of factors;
- To cash back the Council's usable reserves and seek a safe return on these investments.

Similarly there are no changes to the Permitted Investments other than the formality of including investment in the Midlothian Energy Company. (This is a formality as Council has, by agreeing to participate in the Joint Venture Company, accepted that this will be a Permitted Investment.

The Council would still be required to approve Prudential Indicators. These are driven by the capital plans which will also be reported to Council on 23 February 2021.

1.3 Treasury Management Strategy for 2021/22

The strategy for 2021/22 covers two main areas:

Capital issues

- the capital expenditure plans and the prudential indicators (Section 2 of this report);
- The loans fund repayment policy (Section 2.4 of this report).

Treasury management issues

- policy on use of external service providers (Section 1.5);
- the current treasury position (Section 3.1);
- treasury indicators which limit the treasury risk and activities of the Council (Section 3.2);
- prospects for interest rates (Section 3.3);
- the borrowing strategy (Section 3.4);
- policy on borrowing in advance of need (Section 3.5);
- debt rescheduling (Section 3.6);
- the investment strategy (Section 4.1); and
- creditworthiness policy (Section 4.2).

These elements cover the requirements of the Local Government in Scotland Act 2003, the CIPFA Prudential Code, the CIPFA Treasury Management Code and The Scottish Government Local Authority (Capital Finance & Accounting) (Scotland) Regulations 2016.

1.4 Training

The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsibe for scrutiny. A training workshop for Members was held on 5 November 2019 and further training will be arranged as required.

A training workshop in Treasury Management for the Financial Services team, led by the Council's Treasury Management consultants Link Asset Services, took place on 03 March 2016.

1.5 Treasury management consultants

The Council uses Link Asset Services, Treasury Solutions as its external treasury management advisors.

The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers. All decisions will be undertaken with regards to all available information, including, but not solely, our treasury advisers.

It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

2 THE CAPITAL PRUDENTIAL INDICATORS 2021/22 – 2024/25

The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans is reflected in the prudential indicators, which are designed to assist members' overview and confirm capital expenditure plans.

2.1 Capital expenditure

This prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle.

The table below summarises the Capital Expenditure forecasts:-

Table 1: Capital Expenditure	2019/20 Actual £000's	2020/21 Estimate £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's
General Services						
Place	£ 8,155	£ 17,303	£ 22,174	£ 18,498	£ 15,266	£ 12,189
People & Partnerships	£ 24,249	£ 15,149	£ 14,199	£ 36,205	£ 38,685	£ 18,332
Council Transformation	£ 695	£ 83	£ 766	£ 867	£ 7,548	£ 12,755
Provision for Return of Contingencies	£ -	£ (828)	£ (793)	£ (909)	£ (1,367)	£ (1,503)
Total General Services	**£ 33,099**	**£ 31,708**	**£ 36,346**	**£ 54,661**	**£ 60,132**	**£ 41,773**
Total HRA	**£ 24,936**	**£ 19,138**	**£ 107,271**	**£ 110,779**	**£ 76,712**	**£ 28,962**
Combined Total	**£ 58,035**	**£ 50,846**	**£ 143,617**	**£ 165,440**	**£ 136,844**	**£ 70,735**

The table below shows how the Capital Expenditure forecasts are being financed by capital or revenue resources. Any shortfall of resources results in a funding borrowing need.

Members are asked to approve the capital expenditure forecasts and the financing of these forecasts:-

Table 2: Capital Expenditure and Available Financing	2019/20 Actual £000's	2020/21 Estimate £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's
Capital Expenditure						
General Services	£ 33,099	£ 31,708	£ 36,346	£ 54,661	£ 60,132	£ 41,773
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Financed by:						
Capital receipts	£ 315	£ 95	£ 1,020	£ -	£ -	£ -
Capital grants	£ 25,214	£ 14,759	£ 20,475	£ 23,856	£ 17,906	£ 10,073
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Developer/Other Contributions	£ 14,606	£ 3,969	£ 5,287	£ 11,833	£ 11,578	£ 4,115
Net financing need for the year	**£ 17,900**	**£ 32,023**	**£ 98,835**	**£ 126,752**	**£ 105,360**	**£ 48,853**

Note:- The above financing need excludes other long term liabilities, such as PFI and leasing arrangements which already include borrowing instruments.

2.2 The Council's borrowing need (the Capital Financing Requirement)

The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. Any capital expenditure above, which has not immediately been paid for (financed), will increase the CFR.

The CFR does not increase indefinitely, as annual repayments from revenue need to be made which reflect the useful life of capital assets financed from borrowing. From 1st April 2016, Local Authorities may choose whether to use scheduled debt amortisation (loans pool charges) or another suitable method of calculation in order to repay borrowing.

The CFR includes any other long term liabilities (e.g. PFI schemes, finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme already include a borrowing facility and so the Council is not required to separately borrow for these schemes. The Council currently has £53.7m of such schemes within the CFR. The Council is asked to approve the CFR projections below:

Capital Financing Requirement (CFR)						
	2019/20 Actual £000's	2020/21 Estimate £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's
Capital Financing Requirement						
CFR – General Services	£ 113,065	£ 125,918	£ 136,576	£ 160,296	£ 185,194	£ 201,194
CFR – HRA	£ 171,389	£ 181,436	£ 260,020	£ 352,270	£ 420,862	£ 441,004
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Movement in CFR	**£ 34,450**	**£ 12,920**	**£ 85,906**	**£ 112,439**	**£ 89,746**	**£ 32,174**
Movement in CFR represented by						
Net financing need for the year (previous table)	£ 17,900	£ 32,023	£ 98,835	£ 126,752	£ 105,360	£ 48,853
Less Scheduled Debt Amortisation	£ (8,063)	£ (9,123)	£ (9,594)	£ (10,781)	£ (11,870)	£ (12,711)
Less net PFI Finance Lease Principal Payments	£ 24,613	£ (9,980)	£ (3,335)	£ (3,532)	£ (3,744)	£ (3,968)
Movement in CFR	**£ 34,450**	**£ 12,920**	**£ 85,906**	**£ 112,439**	**£ 89,746**	**£ 32,174**

A key aspect of the regulatory and professional guidance is that elected members are aware of the size and scope of any commercial activity in relation to the authority's overall financial position. The capital expenditure figures shown in 2.1 and the details above demonstrate the scope of this activity and, by approving these figures, consider the scale proportionate to the Authority's remaining activity.

2.3 Statutory repayment of loans fund advances

Under the Local Government Finance Circular 7/2016, Council is now required to set out its policy for the statutory repayment of loans fund advances prior to the start of each financial year. The repayment of loans fund advances ensures that the Council makes a prudent provision each year to pay off an element of the accumulated loans fund advances made in previous financial years.

It is proposed to retain the methodology adopted in 2020/21 – that is as follows:-

<u>New Assets</u>

In accordance with Finance Circular 7/2016, for all advances made in relation to the provision of a new asset, the policy will be to defer the commencement of the first principal repayment of the loans fund advance until the financial year following the one in which the asset is first available for use.

<u>Prudent Repayment of Loans Fund Advances</u>

Finance Circular 7/2016 provides a variety of options to Councils for the profiling of the repayment of each loans fund advance, so long as the principle of prudence is maintained. There are 4 options available: (a) Asset Life method; (b) Statutory method; (c) Depreciation method; and (d) Funding/income profile method.

In line with the policy adopted in 2020/21, the Asset Life method shall be used for those assets in Table 6.

Table 6: Asset Classes to adopt the "Asset Life" method

Infrastructure	**Current Loans Fund Advance Period***	**Proposed Loans Fund Advance Period**
New Primary Schools/Extensions	50	60
New Leisure Centres	39	60
New Offices	25	60
Road Upgrades	29	50
Street Lighting Columns	26	50
Structures/Bridges	26	50
Footway/Cyclepaths	30	50
Town Centre Environmental Improvements	20	50
New Care Homes	33	45
Children's Play Equipment	9	20

** Average loans fund advance length*

The annual repayments under the "Asset Life" method for those asset classes as noted above will be calculated using the asset lives and will use the annuity method, to ensure consistency of approach with the Statutory method for all other asset classes (see below). The annuity interest rate that will be used to calculate loans fund principal repayments under the "Asset Life" method will be the in-year loans fund rate, which for 2020/21 is currently estimated to be 2.96%.

For all other asset classes, the policy will be to maintain the practice of previous years and apply what is termed "the Statutory Method" – following the principles of Schedule 3 of the Local Government (Scotland) Act 1975 – with all loans fund advances being repaid by the annuity method. The annuity rate that is proposed to be applied to the loans fund repayments varies will be the in-year loans fund rate, reflecting the Council's current loan and investment portfolio. The loans fund rate for 2020/21 is forecast to be 3.10%

Whilst neither the Depreciation nor the Funding/income profile methods are currently proposed, Council officers will continue to monitor whether it is appropriate to use this for future capital projects.

3 Borrowing

The capital expenditure plans set out in Section 2 provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the the relevant professional codes, so that sufficient cash is available to meet this service activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of approporiate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

3.1 Treasury management portfolio position

The overall treasury management portfolio as at 31 March 2020 and for the position as at 21 January 2021 are shown below for both borrowing and investments.

Loan Type	31 March 2020		21 January 2021	
	Principal Outstanding £000's	Weighted Average Rate	Principal Outstanding £000's	Weighted Average Rate
PWLB Annuity	637	8.90%	597	8.90%
PWLB Maturity	228,824	3.41%	235,424	3.28%
LOBO	20,000	4.51%	20,000	4.51%
Market Loans	18,831	2.68%	18,369	2.68%
Salix Loans	785	0.00%	601	0.00%
Total Loans	**269,077**	**3.44%**	**274,991**	**3.34%**

Investment Type	31 March 2020		21 January 2021	
	Principal Outstanding £000's	Weighted Average Rate	Principal Outstanding £000's	Weighted Average Rate
Bank Call Accounts	11,476	0.30%	17,687	0.01%
Money Market Funds	14,902	0.31%	29,817	0.01%
Bank Notice Accounts	14,985	1.10%	14,985	0.58%
Bank Fixed Term Deposits	30,000	1.25%	-	n/a
Other Local Authorities	40,000	1.56%	70,000	1.55%
Total Investments	**111,363**	**1.12%**	**132,489**	**0.89%**

The Council's forward projections for borrowing and investments are summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

Net Borrowing Requirement	2019/20 Actual £000's	2020/21 Estimate £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's
External Debt						
Debt at 1 April	£ 237,278	£ 269,077	£ 274,991	£ 363,996	£ 479,217	£ 571,889
Actual/Expected change in Debt	£ 31,799	£ 5,914	£ 89,005	£ 115,221	£ 92,672	£ 35,314
Other long-term liabilities (OLTL)	£ 85,135	£ 109,748	£ 99,768	£ 96,433	£ 92,901	£ 89,157
Actual/Expected change in OLTL	£ 24,613	£ (9,980)	£ (3,335)	£ (3,532)	£ (3,744)	£ (3,968)
Actual/Expected Gross Debt at 31 March	**£ 378,825**	**£ 374,759**	**£ 460,429**	**£ 572,118**	**£ 661,046**	**£ 692,392**
The Capital Financing Requirement	**£ 394,202**	**£ 407,122**	**£ 493,029**	**£ 605,467**	**£ 695,213**	**£ 727,387**
Under / (over) borrowing	**£ 15,377**	**£ 32,363**	**£ 32,599**	**£ 33,349**	**£ 34,167**	**£ 34,995**
Investments						
Cash & Cash Equivalents	£ 26,378	£ 35,000	£ 10,000	£ 10,000	£ 10,000	£ 10,000
Short-Term Investments	£ 84,985	£ 84,985	£ 84,985	£ 69,985	£ 69,985	£ 59,985
Total Investments	**£ 111,363**	**£ 119,985**	**£ 94,985**	**£ 79,985**	**£ 79,985**	**£ 69,985**

Within the range of prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well-defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2021/22 and the following three financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

The Chief Officer Corporate Solutions reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

3.2 Treasury Indicators: limits to borrowing activity

The operational boundary

This is the limit beyond which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt.

For this Council:-

- the Operational Boundary for Borrowing has been calculated to equate directly to the in-year value of the CFR over the current and following 4 financial years (2020/21 to 2024/25); and
- the Operational Boundary for Other Long-Term Liabilities has been calculated to equate directly to the in-year CFR for Other Long-Term Liabilities, given the known contractual provisions for the repayment of debt within the Council's two PPP agreements.

Operational Boundary					
	2020/21 Estimate £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's
Operational Boundary - Borrowing	£ 307,354	£ 396,596	£ 512,566	£ 606,056	£ 642,198
Operational Boundary - Other long term liabilities	£ 99,768	£ 96,433	£ 92,901	£ 89,157	£ 85,189
Total	**£ 407,122**	**£ 493,029**	**£ 605,467**	**£ 695,213**	**£ 727,387**

The authorised limit for external debt

A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

1. This is the statutory limit (Affordable Capital Expenditure Limit) determined under section 35 (1) of the Local Government in Scotland Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised;
2. The Authorised Limit for Borrowing has been calculated by taking the maximum value of the CFR over the next 4 financial years (2021/22 to 2024/25), with the total forecast level of capital receipts and developer contributions ***added back*** to this figure (given the inherent uncertainty regarding the timing and value of these receipts/contributions):-
    a. Council is therefore asked to approve that, rather than restrict borrowing to £307.354 million for 2020/21, £396.596 million for 2021/22, £512.566 million for 2022/23, £606.056 million for 2023/24, and £642.198 million for 2024/25, that permission be granted to borrow up to the 2024/25 Authorised Limit for Borrowing of £676.508 million as shown in the table below), if market conditions support this action;
    b. It is expected that, given current market conditions, no borrowing in advance of need for the remainder of 2020/21 and throughout 2021/22 will be undertaken, and that all borrowing undertaken in these periods will be aligned to match as closely as possible to the incurrence of capital expenditure in the remainder of 2020/21 and throughout 2021/22. Should market conditions materially change and which would support any borrowing in advance of need, any borrowing drawn would be supported by a business case which will appraise the anticipated savings in borrowing costs (from expected increases in rates later in the year / in forthcoming years) against the carrying cost associated with borrowing in advance of need

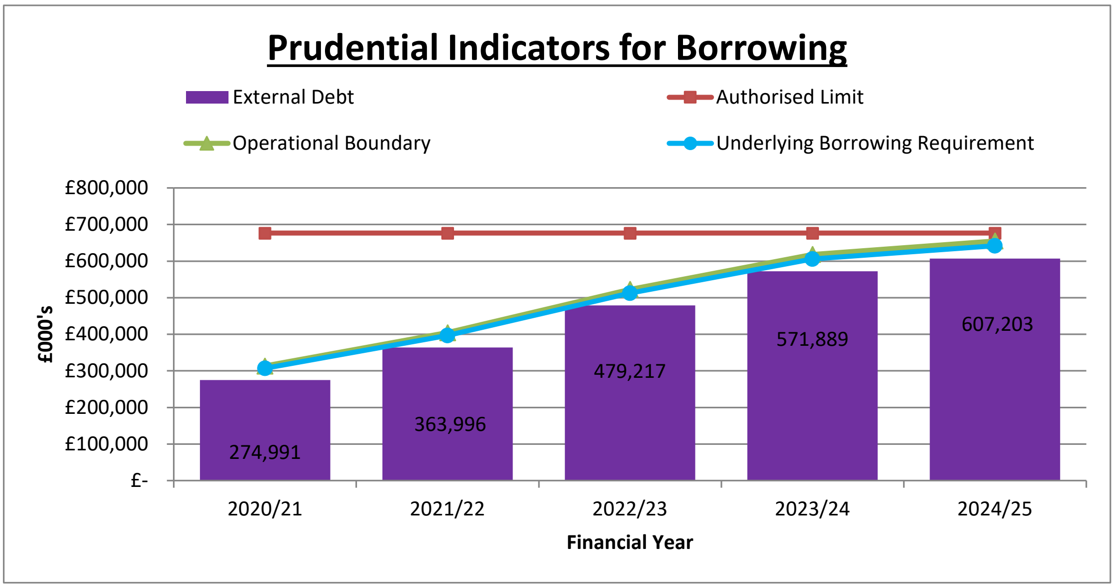
c. This would have the effect of securing lower costs for future years but care would be taken to ensure that the cost of carry from borrowing early is minimized and that the maturity structure of all debt is sufficiently robust to ensure that the CFR at 31 March 2025 remains achievable.

d. The authorised limit therefore reflects a level of borrowing which, while not desired, could be afforded but is not sustainable.

3. The Authorised Limit for Other Long-Term Liabilities has been calculated to equate directly to the Operational Boundary for Other Long-Term Liabilities, given the known contractual provisions for the repayment of debt within the Council's four DBFM agreements.

Authorised Limit					
	2020/21 Estimate £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's
Authorised Limit - Borrowing	£676,508	£676,508	£ 676,508	£ 676,508	£ 676,508
Authorised Limit - Other long term liabilities	£ 99,768	£ 96,433	£ 92,901	£ 89,157	£ 85,189
Total Debt	**£776,276**	**£772,941**	**£ 769,409**	**£ 765,665**	**£ 761,697**

Reconciliation of Authorised Limit for Borrowing	
	£000's
CFR - General Services at 31 March 2025	£ 201,194
CFR - HRA at 31 March 2025	£ 441,004
Capital Receipts 2020/21 unrealised to date	£ 95
Capital Receipts 2021/22 to 2024/25	£ 1,250
Developer/Other Contributions 2020/21 Unrealised to date	£ 153
Developer/Other Contributions 2021/22 to 2024/25	£ 32,813
Authorised Limit for Borrowing	**£ 676,508**



3.3 Prospects for interest rates

The Council has appointed Link Asset Services as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. The following table gives our central view.

Link Group Interest Rate View 9.11.20													
These Link forecasts have been amended for the reduction in PWLB margins by 1.0% from 26.11.20													
	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
BANK RATE	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
6 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
12 month ave earnings	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
5 yr PWLB	0.80	0.80	0.80	0.80	0.90	0.90	0.90	0.90	0.90	1.00	1.00	1.00	1.00
10 yr PWLB	1.10	1.10	1.10	1.10	1.20	1.20	1.20	1.20	1.20	1.30	1.30	1.30	1.30
25 yr PWLB	1.50	1.60	1.60	1.60	1.60	1.70	1.70	1.70	1.70	1.80	1.80	1.80	1.80
50 yr PWLB	1.30	1.40	1.40	1.40	1.40	1.50	1.50	1.50	1.50	1.60	1.60	1.60	1.60

The coronavirus outbreak has done huge economic damage to the UK and economies around the world. After the Bank of England took emergency action in March to cut Bank Rate to first 0.25%, and then to 0.10%, it left Bank Rate unchanged at its subsequent meetings to 16th December, although some forecasters had suggested that a cut into negative territory could happen. However, the Governor of the Bank of England has made it clear that he currently thinks that such a move would do more damage than good and that more quantitative easing is the favoured tool if further action becomes necessary. As shown in the forecast table above, no increase in Bank Rate is expected in the near-term as economic recovery is expected to be only gradual and, therefore, prolonged.

Gilt yields / PWLB rates

There was much speculation during the second half of 2019 that bond markets were in a bubble which was driving bond prices up and yields down to historically very low levels. The context for that was a heightened expectation that the US could have been heading for a recession in 2020. In addition, there were growing expectations of a downturn in world economic growth, especially due to fears around the impact of the trade war between the US and China, together with inflation generally at low levels in most countries and expected to remain subdued. Combined, these conditions were conducive to very low bond yields. While inflation targeting by the major central banks has been successful over the last thirty years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers. This means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. The consequence of this has been the gradual lowering of the overall level of interest rates and bond yields in financial markets over the last 30 years. Over the year prior to the coronavirus crisis, this has seen many bond yields up to 10 years turn negative in the Eurozone. In addition, there has, at times, been an inversion of bond yields in the US whereby 10 year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession. The other side of this coin is that bond prices are elevated as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities.

Gilt yields had therefore already been on a generally falling trend up until the coronavirus crisis hit western economies. After gilt yields spiked up during the financial crisis in March, we have seen these yields fall sharply to unprecedented lows as investors panicked during March in selling shares in anticipation of impending recessions in western economies, and moved cash into safe haven assets i.e. government bonds. However, major western central banks took rapid action to deal with excessive stress in financial markets during March, and started massive quantitative easing purchases of government bonds: this also acted to put downward pressure on government bond yields at a time when there has been a huge and quick expansion of government expenditure financed by issuing government bonds. Such unprecedented levels of issuance in "normal" times would have caused bond yields to rise sharply. Gilt yields and PWLB rates have been at remarkably low rates so far during 2020/21.

As the interest forecast table for PWLB certainty rates above shows, there is expected to be little upward movement in PWLB rates over the next two years as it will take economies, including the UK, a prolonged period to recover all the momentum they have lost in the sharp recession caused during the coronavirus shut down period. From time to time, gilt yields, and therefore PWLB rates, can be subject to exceptional levels of volatility due to geo-political, sovereign debt crisis, emerging market developments and sharp changes in investor sentiment, (as shown on 9th November when the first results of a successful COVID-19 vaccine trial were announced). Such volatility could occur at any time during the forecast period.

Investment Rates

- Investment returns are likely to remain exceptionally low during 2021/22 with little increase in the following two years.

- Borrowing interest rates fell to historically very low rates as a result of the COVID crisis and the quantitative easing operations of the Bank of England: indeed, gilt yields up to 6 years were negative during most of the first half of 20/21.

- On 25th November 2020, the Chancellor announced the conclusion to the review of margins over gilt yields for PWLB rates; the standard and certainty margins were reduced by 1% but a prohibition was introduced to deny access to borrowing from the PWLB for any local authority which had purchase of assets for yield in its three year capital programme. The new margins over gilt yields are as follows: -

    - PWLB Standard Rate is gilt plus 100 basis points (G+100bps)
    - PWLB Certainty Rate is gilt plus 80 basis points (G+80bps)
    - PWLB HRA Standard Rate is gilt plus 100 basis points (G+100bps)
    - PWLB HRA Certainty Rate is gilt plus 80bps (G+80bps)
    - Local Infrastructure Rate is gilt plus 60bps (G+60bps)

A more detailed interest rate view and economic commentary is provided at appendix 5.1.

3.4 Borrowing strategy

The Council is currently maintaining a partial under-borrowed (internally-borrowed) position (£32.4 million projected at the end of financial year 2020/21). 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 still an issue to be considered.

Against this background and the risks within the economic forecast, caution will be adopted with the 2021/22 treasury operations. The Chief Officer, Corporate Solutions will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

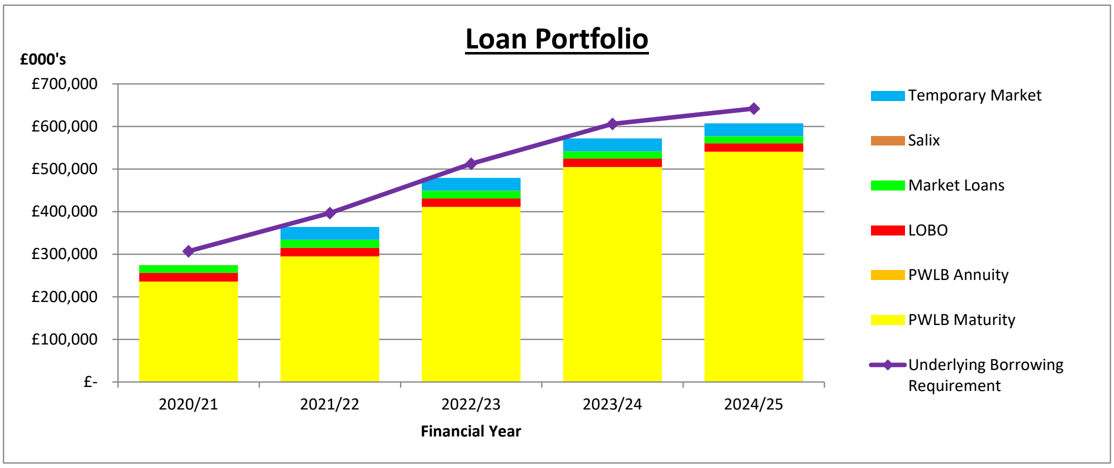
- *if it was felt that there was a significant risk of a sharp FALL in long and short term rates* (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered;

- *if it was felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast,* perhaps arising from an acceleration in the rate of increase in central rates in the USA and UK, an increase in world economic activity, or a sudden increase in inflation risks, then the portfolio position will be re-appraised. Most likely, fixed rate funding will be drawn whilst interest rates are lower than they are projected to be in the next few years.

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

Borrowing is undertaken to finance the Council's approved Capital plans and to do so in the most cost effective way. As can been noted from Table 3 above the Council has a significant borrowing requirement across the forthcoming 4 financial years (2021/22 to 2024/25).

The Council's projected loan portfolio over the period 2020/21 to 2024/25 is shown in graphical format below.



On 26 November 2020, in parallel to Chancellor of the Exchequer Spending Review Announcement, the UK Government's Debt Management Office implemented changes to the PWLB lending rates. PWLB's non-HRA lending rate was cut from its level of gilts + 180 basis points to gilts + 100 basis points. Rates for medium-long term borrowing rates for both HRA and non-HRA purposes are therefore at historically low levels and significantly below historical averages.

At the same time, the current low Bank of England base rate level of 0.10%, and the expectation that there will be no base rate rises in the short-medium term, means that continued utilisation of temporary borrowing within the Council's overall loan portfolio would continue to provide a cost-effective solution to the Council. The quantum of this will continue to be assessed against the backdrop of potential long term costs if the opportunity is missed to take PWLB or other market loans at historically low medium-long term rates, particularly given the projected gradual rise in PWLB rates.

It is expected that the majority of the remaining borrowing requirement to fund capital expenditure incurred in the remainder of 2020/21 and through to 2024/25 shall be sourced from a blend of temporary borrowing and by locking in to longer term PWLB borrowing to manage longer term cost and risk for the loan portfolio. The opportunity also continues to exist to consider further loans on a 'forward dealing' basis, and officers will continue to explore the viability of these loans throughout the remainder of 2020/21 and into 2021/22.

The projected under-borrowing position as at 31 March 2021 is £31.362 million. This means that the Council have funded an equivalent amount of capital expenditure on new assets through internal resources / working capital, and have not committed to fixed long term borrowing to fund this capital expenditure through loans from external counterparties. Other options available to the Council would be to borrow a further £31.362 million from external loan providers to fully finance the capital investment which would result in an additional cost to the revenue budget; or to mature the existing £69.985 million of deposits that are cash backing the Council's reserves and defer equivalent long term borrowing over the current and forthcoming financial years, until the reserves are utilised. Whilst this may result in savings against the Council's current loan charges in the short term it will expose the Council to a significant risk in the medium to long term by having over £100 million exposure to interest rate and refinancing risk.

Council officers have assessed that the current level of the under-borrowed position is a prudent approach which balances (a) the short-medium term cashflow benefit and saving to the revenue budget of using internal resources / working capital at a lower cost against (b) the longer-term risk of not locking into longer-term borrowing at still historically low longer term borrowing rates.

Officers will ensure that any loans taken are drawn to match the existing maturity and projected capital expenditure profiles as closely as possible, that proposed interest rates continue to sit below forward interest rate projections, and that the overall borrowing remains within the Authorised Limit proposed below.

It is expected that, given current market conditions, no borrowing in advance of need for the remainder of 2020/21 and throughout 2021/22 will be undertaken, and that all borrowing undertaken in these periods will be aligned to match as closely as possible to the incurrence of capital expenditure over this period. Should market conditions materially change and which would support any borrowing in advance of need, any borrowing drawn would be supported by a business case which will appraise the anticipated savings in borrowing costs (from expected increases in rates later in the year / in forthcoming years) against the carrying cost associated with borrowing in advance of need.

Treasury management limits on activity

There are three debt related treasury activity limits. The purpose of these are 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 for borrowing based upon the gross debt position, and variable interest rates for investments based upon the total investment position;
- Upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates for both borrowing and investments;
- Maturity structure of borrowing. These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

The Council is asked to approve the following treasury indicators and limits:

Upper Limits on Exposure to Fixed and Variable Interest Rates 2021/22	
Interest rate exposures	**Upper Limit**
Limits on fixed interest rates based on gross debt	100.00%
Limits on variable interest rates based on gross debt	30.00%
Limits on fixed interest rates based on investments	100.00%
Limits on variable interest rates based on investments	100.00%

Maturity Structure of Borrowing 2021/22		
Maturity structure of fixed interest rate borrowing 2021/22	**Lower**	**Upper**
Under 12 months	0.00%	50.00%
12 months to 2 years	0.00%	50.00%
2 years to 5 years	0.00%	50.00%
5 years to 10 years	0.00%	50.00%
10 years to 20 years	0.00%	50.00%
20 years to 30 years	0.00%	50.00%
30 years to 40 years	0.00%	50.00%
40 years to 50 years	0.00%	50.00%
50 years and above	0.00%	50.00%
Maturity structure of variable interest rate borrowing 2021/22	**Lower**	**Upper**
Under 12 months	0.00%	30.00%
12 months to 2 years	0.00%	30.00%
2 years to 5 years	0.00%	30.00%
5 years to 10 years	0.00%	30.00%
10 years to 20 years	0.00%	30.00%
20 years to 30 years	0.00%	30.00%
30 years to 40 years	0.00%	30.00%
40 years to 50 years	0.00%	30.00%
50 years and above	0.00%	30.00%

3.5 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 (as detailed in Section 3.2) 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.

3.6 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.

4 ANNUAL INVESTMENT STRATEGY

4.1 Investment policy

The Council's investment policy implements the requirements of the following: -

- Local Government Investments (Scotland) Regulations 2010, (and accompanying Finance Circular 5/2010);
- CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2017 ("the Code");
- CIPFA Treasury Management Guidance Notes 2018

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

Ratings will not be the sole determinant of the quality of an institution; it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To this end the Council will engage with its advisors to maintain a monitor on market pricing such as "**credit default swaps**" and overlay that information on top of the credit ratings.

Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

This authority has defined the list of **types of investment instruments** that are permitted investments authorised for use in appendix 5.2. Appendix 5.3 expands on the risks involved in each type of investment and the mitigating controls.

Lending limits, (maturity and amounts), for each counterparty will be set through applying and matrix table in Section 4.2 (maturity durations), with investments only placed with counterparties from countries with a specified minimum sovereign rating, (see paragraph 4.3). Lending per Country and Institution will be set through the application of the criteria in Section 4.3 (amounts).

Transaction limits are set for each type of investment in appendix 5.2.

This authority will set a limit for the amount of its investments which are invested for longer than 365 days, (see paragraph 4.4).

This authority has engaged external consultants, (see paragraph 1.5), to provide expert advice on how to optimise an appropriate balance of security, liquidity and yield, given the risk appetite of this authority in the context of the expected level of cash balances and need for liquidity throughout the year.

All investments will be denominated in sterling.

However, this authority will also pursue **value for money** in treasury management and will monitor the yield from investment income against appropriate benchmarks for investment performance, (see paragraph 4.5). Regular monitoring of investment performance will be carried out during the year.

4.2 Creditworthiness policy

This Council applies the creditworthiness service provided by Link Asset Services. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody's and Standard and Poor's. The credit ratings of counterparties are supplemented with the following overlays:-

- credit watches and credit outlooks from credit rating agencies;
- CDS spreads to give early warning of likely changes in credit ratings;
- sovereign ratings to select counterparties from only the most creditworthy countries.

This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the suggested duration for investments. The Council will therefore use counterparties within the following durational bands:-

Table 14: Recommended Maximum Durations for Investments

Link Asset Services Colour Code	Maximum Suggested Duration for Investment
Yellow	6 years*
Dark Pink	6 years**
Light Pink	6 years**
Purple	3 years
Blue	2 years***
Orange	2 years
Red	8 months
Green	120 days
No colour	Not to be used

* *Note the yellow colour category is for:- UK Government Debt, or its equivalent, Money Market Funds (MMF's), and collateralised deposits where the collateral is UK Government Debt*

** *Dark Pink for Ultra Short Dated Bond Funds with a credit score of 1.25*
Light Pink for Ultra Short Dated Bond Funds with a credit score of 1.5

*** *Applies only to nationalised or semi-nationalised UK Banks*

Note that the maximum suggested durations listed above have been extended by 1 year (when compared to the suggested maximum durations provided by Capita) for the Yellow, Dark Pink, Light Pink, Purple, Blue and Orange categories, to allow flexibility around these durations on the margins e.g. the placement of a 13 month fixed term deposit for a counterparty rated Orange or Blue. Equally, the maximum suggested duration for the Red category has been extended by a month to 8 months, on the same basis. A thorough appraisal of the additional risk involved in extending the duration of any deposit (marginally) beyond the maximum suggested by Capita, against any enhanced value to the portfolio, will be undertaken prior to the placement of any deposit.

The Link Asset Services creditworthiness service uses a wider array of information than just primary ratings. Furthermore, by using a risk weighted scoring system, it does not give undue preponderance to just one agency's ratings.

Typically the minimum credit ratings criteria the Council use will be (Fitch or equivalents):-

- Short term rating F1;
- Long term rating A-.

There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

All credit ratings will be monitored weekly. The Council is alerted to changes to ratings of all three agencies through its use of the Link 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 spreads against the iTraxx benchmark and other market data on a daily basis via its Passport website, provided exclusively to the Council by Link asset Services. 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, information on sovereign support for banks and the credit ratings of that supporting government.

UK banks – ring fencing

The largest UK banks, (those with more than £25bn of retail / Small and Medium-sized Enterprise (SME) deposits), are required, by UK law, to separate core retail banking services from their investment and international banking activities by 1st January 2019. This is known as "ring-fencing". Whilst smaller banks with less than £25bn in deposits are exempt, they can choose to opt up. Several banks are very close to the threshold already and so may come into scope in the future regardless.

Ring-fencing is a regulatory initiative created in response to the global financial crisis. It mandates the separation of retail and SME deposits from investment banking, in order to improve the resilience and resolvability of banks by changing their structure. In general, simpler, activities offered from within a ring-fenced bank, (RFB), will be focused on lower risk, day-to-day core transactions, whilst more complex and "riskier" activities are required to be housed in a separate entity, a non-ring-fenced bank, (NRFB). This is intended to ensure that an entity's core activities are not adversely affected by the acts or omissions of other members of its group.

While the structure of the banks included within this process may have changed, the fundamentals of credit assessment have not. The Council will continue to assess the new-formed entities in the same way that it does others and those with sufficiently high ratings, (and any other metrics considered), will be considered for investment purposes.

4.3 Country and sector limits

The Council has determined that it will only use approved counterparties from the UK and from countries with a minimum sovereign credit rating of AA- from Fitch.

The list of countries that qualify using the above criteria as at the date of this report are shown in Appendix 5.4. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

The Council will avoid a concentration of investments in too few counterparties or countries by adopting a spreading approach to investing whereby no more than £30 million will be invested in Lloyds Banking Group and the Royal Bank of Scotland Group, £15 million in any other UK counterparty, and £15 million in any one counterparty, group or country outwith the UK.

4.4 Investment strategy

Current Deposits

As at 21 January 2021, the Council's deposits were as follows:-

Counterparty	**Amount £000's**	**Security *Long/Short Term Rating* (Colour)***	**Liquidity**	**Yield**
MMF Aberdeen	14,908	AAAmmf *(Yellow)*	Instant Access	0.01%
MMF Federated	14,907	AAAmmf *(Yellow)*	Instant Access	0.01%
MMF LGIM	2	AAAmmf *(Yellow)*	Instant Access	0.01%
RBS Call Account	17,687	A+/F1 *(Blue)*	Instant Access	0.01%
Santander	14,985	A+/F1 (*Red*)	180 day notice account	0.58%
Rushmoor Borough Council	10,000	Quasi-UK Government (AA- / *Yellow*)	Start: 22 Jul 2019 End: 22 Jan 2021	1.15%
Wokingham Borough Council	15,000	Quasi-UK Government (AA- / *Yellow*)	Start: 25 Mar 2020 End: 24 Mar 2023	1.60%
Medway Council	15,000	Quasi-UK Government (AA- / *Yellow*)	Start: 30 Mar 2020 End: 30 Mar 2022	1.80%
London Borough of Croydon	13,000	Quasi-UK Government (AA- / *Yellow*)	Start: 03 Apr 2020 End: 03 Oct 2022	1.85%
Stoke on Trent City Council	2,000	Quasi-UK Government (AA- / *Yellow*)	Start: 06 Apr 2020 End: 06 Apr 2023	1.60%
London Borough of Waltham Forest	15,000	Quasi-UK Government (AA- / *Yellow*)	Start: 06 Apr 2020 End: 06 Apr 2023	1.25%
Total	**132,489**			

** Credit Rating from Fitch*
*** Colour represents maximum recommended duration for investment per Link Asset Services, Treasury Solutions Credit Scoring methodology – see Appendix 2.*

In-house funds. Investments will be made with reference to the core balance and cash flow requirements and the outlook for short -term interest rates. Greater returns are usually obtainable by investing for longer periods. While an element of cash balances are required in order to manage the ups and downs of cash flow, where cash sums can be identified that could be invested for longer periods, the value to be obtained from longer term investments will be carefully assessed.

- If it is thought that Bank Rate is likely to rise significantly within the time horizon being considered, then consideration will be given to keeping most investments as being short term or variable;
- Conversely, if it is thought that Bank Rate is likely to fall within that time period, consideration will be given to locking in higher rates currently obtainable, for longer periods.

Investment returns expectations

Bank Rate is unlikely to rise from 0.10% for a considerable period. The suggested budgeted investment earnings rates for returns on investments placed for periods up to about three months during each financial year are as follows (the long term forecast is for periods over 10 years in the future):

Average earnings in each year	
2020/21	0.10%
2021/22	0.10%
2022/23	0.10%
2023/24	0.10%
2024/25	0.25%
Long term later years	0.50%

- The overall balance of risks to economic growth in the UK is probably now skewed to the upside, but is subject to major uncertainty due to the virus and how quickly successful vaccines may become available and widely administered to the population. It may also be affected by what, if any, deal the UK agrees as part of Brexit.
- There is relatively little UK domestic risk of increases or decreases in Bank Rate and significant changes in shorter term PWLB rates. The Bank of England has effectively ruled out the use of negative interest rates in the near term and increases in Bank Rate are likely to be some years away given the underlying economic expectations. However, it is always possible that safe haven flows, due to unexpected domestic developments and those in other major economies, or a return of investor confidence in equities, could impact gilt yields, (and so PWLB rates), in the UK.

Negative investment rates

While the Bank of England said in August / September 2020 that it is unlikely to introduce a negative Bank Rate, at least in the next 6 -12 months, and in November omitted any mention of negative rates in the minutes of the meeting of the Monetary Policy Committee, some deposit accounts are already offering negative rates for shorter periods. As part of the response to the pandemic and lockdown, the Bank and the Government have provided financial markets and businesses with plentiful access to credit, either directly or through commercial banks. In addition, the Government has provided large sums of grants to local authorities to help deal with the COVID crisis; this has caused some local authorities to have sudden large increases in cash balances searching for an investment home, some of which was only very short term until those sums were able to be passed on.

As for money market funds (MMFs), yields have continued to drift lower. Some managers have already resorted to trimming fee levels to ensure that net yields for investors remain in positive territory where possible and practical. Investor cash flow uncertainty, and the need to maintain liquidity in these unprecedented times, has meant there is a surfeit of money swilling around at the very short end of the market. This has seen a number of market operators, now including the DMADF, offer nil or negative rates for very short term maturities. This is not universal, and MMFs are still offering a marginally positive return, as are a number of financial institutions for investments at the very short end of the yield curve.

Inter-local authority lending and borrowing rates have also declined due to the surge in the levels of cash seeking a short-term home at a time when many local authorities are probably having difficulties over accurately forecasting when disbursements of funds received will occur or when further large receipts will be received from the Government.

Investment treasury indicator and limit - total principal funds invested for greater than 365 days. These limits are set with regard to the Council's liquidity requirements and expected usable reserve forecasts, and are based on the availability of funds after each year-end.

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

Principal Sums Invested for > 365 Days			
	2019/20	2020/21	2021/22
Limit	£70m	£70m	£70m

The current strategy as outlined in the body of these reports is to continue to cash-back the Council's balance sheet reserves. It is expected that the majority of this will be in the form of fixed term deposits and/or certificates of deposit. Given expected reserve forecasts, in particular the short-medium term forecast for the Council's Capital Fund and HRA Reserve, the limit for prinicipal sums invested for > 365 days has been retained at £70m.

For its cash flow generated balances, the Council will seek to utilise its business reserve instant access accounts and money market funds.

4.5 Investment risk benchmarking

The Council will use an investment benchmark to assess the investment performance of its investment portfolio of 12 month LIBID compounded. The Council also participates in Investment Benchmarking groups with Link Asset Services whereby performance with other Benchmarking club members and the wider Scottish and UK Local Authority Investment benchmarking is compared.

4.6 End of year investment report

At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

5 Appendices

1. Economic background
2. Treasury Management Practice 1 – Permitted Investments
3. Treasury Management Practice 1 – Credit and Counterparty Risk Management
4. Approved countries for investments
5. Treasury management scheme of delegation
6. The treasury management role of the section 95 officer

5.1 APPENDIX: Economic Background

- **UK.** The key quarterly meeting of the Bank of England Monetary Policy Committee kept **Bank Rate** unchanged on 5.11.20. However, it revised its economic forecasts to take account of a second national lockdown from 5.11.20 to 2.12.20 which is obviously going to put back economic recovery and do further damage to the economy. It therefore decided to do a further tranche of **quantitative easing (QE) of £150bn**, to start in January when the current programme of £300bn of QE, announced in March to June, runs out. It did this so that "announcing further asset purchases now should support the economy and help to ensure the unavoidable near-term slowdown in activity was not amplified by a tightening in monetary conditions that could slow the return of inflation to the target".
- Its forecasts appeared, at that time, to be rather optimistic in terms of three areas:
    - o The economy would recover to reach its pre-pandemic level in Q1 2022
    - o The Bank also expected there to be excess demand in the economy by Q4 2022.
    - o CPI inflation was therefore projected to be a bit above its 2% target by the start of 2023 and the "inflation risks were judged to be balanced".
- Significantly, there was no mention of **negative interest rates** in the minutes or Monetary Policy Report, suggesting that the MPC remains some way from being persuaded of the case for such a policy, at least for the next 6 -12 months. However, rather than saying that it "stands ready to adjust monetary policy", the MPC this time said that it will take "whatever additional action was necessary to achieve its remit". The latter seems stronger and wider and may indicate the Bank's willingness to embrace new tools.
- One key addition to **the Bank's forward guidance in August** was a new phrase in the policy statement, namely that "it does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% target sustainably". That seems designed to say, in effect, that even if inflation rises to 2% in a couple of years' time, do not expect any action from the MPC to raise Bank Rate – until they can clearly see that level of inflation is going to be persistently above target if it takes no action to raise Bank Rate. Our Bank Rate forecast currently shows no increase, (or decrease), through to quarter 1 2024 but there could well be no increase during the next five years as it will take some years to eliminate spare capacity in the economy, and therefore for inflationary pressures to rise to cause the MPC concern. **Inflation** is expected to briefly peak at just over 2% towards the end of 2021, but this is a temporary short lived factor due to base effects from twelve months ago falling out of the calculation, and so is not a concern. Looking further ahead, it is also unlikely to be a problem for some years as it will take a prolonged time for spare capacity in the economy, created by this downturn, to be used up.

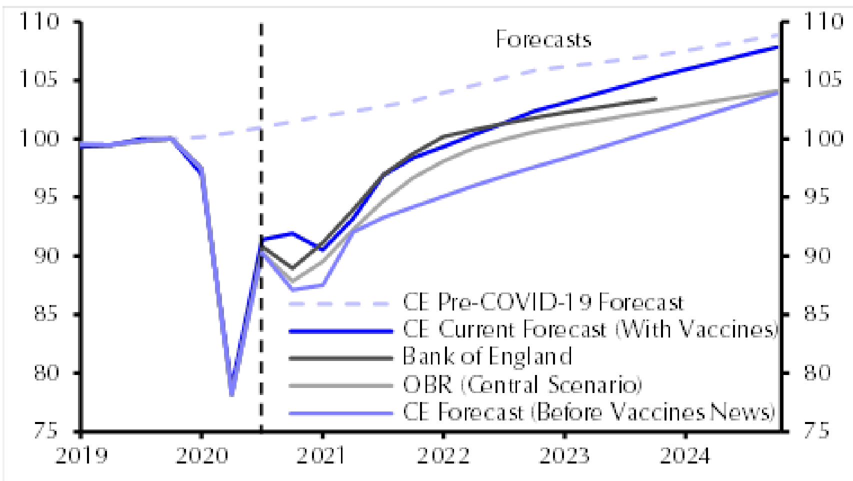
- **Public borrowing** was forecast in November by the Office for Budget Responsibility (the OBR) to reach £394bn in the current financial year, the highest ever peace time deficit and equivalent to 19% of GDP. In normal times, such an increase in total gilt issuance would lead to a rise in gilt yields, and so PWLB rates. However, the QE done by the Bank of England has depressed gilt yields to historic low levels, (as has similarly occurred with QE and debt issued in the US, the EU and Japan). This means that new UK debt being issued, and this is being done across the whole yield curve in all maturities, is locking in those historic low levels through until maturity. In addition, the UK has one of the longest average maturities for its entire debt portfolio, of any country in the world. Overall, this means that the total interest bill paid by the Government is manageable despite the huge increase in the total amount of debt. The OBR was also forecasting that the government will still be running a budget deficit of £102bn (3.9% of GDP) by 2025/26. However, initial impressions are that they have taken a pessimistic view of the impact that vaccines could make in the speed of economic recovery.

- Overall, **the pace of recovery** was not expected to be in the form of a rapid V shape, but a more elongated and prolonged one. The initial recovery was sharp after quarter 1 saw growth at -3.0% followed by -18.8% in quarter 2 and then an upswing of +16.0% in quarter 3; this still left the economy 8.6% smaller than in Q4 2019. While the one month second national lockdown that started on 5th November caused a further contraction of 5.7% m/m in November, this was much better than had been feared and showed that the economy is adapting to new ways of working. This left the economy 'only' 8.6% below the pre-crisis level.

- **Vaccines – the game changer.** The Pfizer announcement on 9th November of a successful vaccine has been followed by approval of the Oxford University/AstraZeneca and Moderna vaccines. The Government has a set a target to vaccinate 14 million people in the most at risk sectors of the population by 15th February; as of mid-January, it has made good, and accelerating progress in hitting that target. The aim is to vaccinate all adults by September. This means that the national lockdown starting in early January, could be replaced by regional tiers of lighter restrictions, beginning possibly in Q2. At that point, there would be less reason to fear that hospitals could become overwhelmed any more. Effective vaccines have radically improved the economic outlook so that it may now be possible for GDP to recover to its pre-virus level as early as Q1 2022. These vaccines have enormously boosted confidence that **life could largely return to normal during the second half of 2021**. With the household saving rate having been exceptionally high since the first lockdown in March, there is plenty of pent-up demand and purchasing power stored up for when life returns to normal.

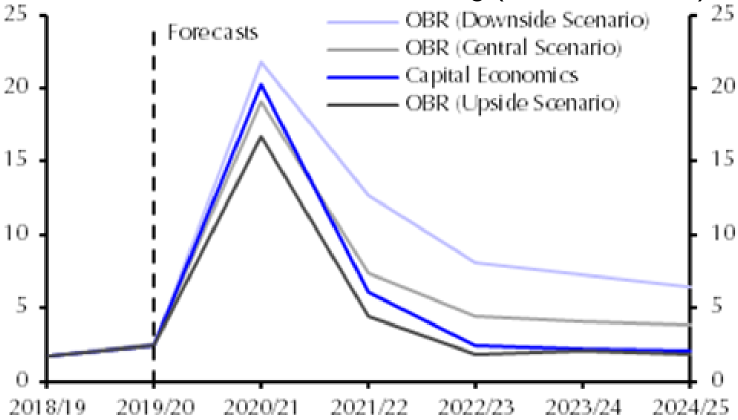
- Provided that both monetary and fiscal policy are kept loose for a few years yet, then it is still possible that in the second half of this decade, the economy may be no smaller than it would have been if COVID-19 never happened. The significant risk is if another mutation of COVID-19 appears that defeats the current batch of vaccines. However, now that science and technology have caught up with understanding this virus, new vaccines ought to be able to be developed more quickly to counter such a development, and vaccine production facilities are being ramped up around the world.

Chart: Level of real GDP (Q4 2019 = 100)



This recovery of growth which eliminates the effects of the pandemic by about the middle of the decade, would have major repercussions for public finances as it would be consistent with the government deficit falling to around 2.5% of GDP without any tax increases. This would be in line with the OBR's most optimistic forecast in the graph below, rather than their current central scenario which predicts a 4% deficit due to assuming much slower growth. However, Capital Economics forecasts assumed that politicians do not raise taxes or embark on major austerity measures and so, (perversely!), depress economic growth and recovery.

Chart: Public Sector Net Borrowing (as a % of GDP)



- There will still be some **painful longer term adjustments** as e.g. office space and travel by planes, trains and buses may not recover to their previous level of use for several years, or possibly ever, even if vaccines are fully successful in overcoming the current virus. There is also likely to be a **reversal of globalisation** as this crisis has exposed how vulnerable long-distance supply chains are. On the other hand, **digital services** are one area that has already seen huge growth.

- **Brexit.** The final agreement of a trade deal on 24.12.20 has eliminated a significant downside risk for the UK economy. The initial agreement only covers trade so there is further work to be done on the services sector where temporary equivalence has been granted in both directions between the UK and EU; that now needs to be formalised on a permanent basis. As the forecasts in this report were based on an assumption of a Brexit agreement being reached, there is no need to amend these forecasts.

- **Monetary Policy Committee meeting of 17 December.** All nine Committee members voted to keep interest rates on hold at +0.10% and the Quantitative Easing (QE) target at £895bn. The MPC commented that the successful rollout of vaccines had reduced the downsides risks to the economy that it had highlighted in November. But this was caveated by it saying, "Although all members agreed that this would reduce downside risks, they placed different weights on the degree to which this was also expected to lead to stronger GDP growth in the central case." So, while vaccines are a positive development, in the eyes of the MPC at least, the economy is far from out of the woods in the shorter term. The MPC, therefore, voted to extend the availability of the Term Funding Scheme, with additional incentives for small and medium size enterprises for six months from 30.4.21 until 31.10.21. (The MPC had assumed that a Brexit deal would be agreed.)

- **Fiscal policy.** In the same week as the MPC meeting, the Chancellor made a series of announcements to provide further support to the economy: -
  - An extension of the COVID-19 loan schemes from the end of January 2021 to the end of March.
  - The furlough scheme was lengthened from the end of March to the end of April.
  - The Budget on 3.3.21 will lay out the "next phase of the plan to tackle the virus and protect jobs". This does not sound like tax rises are imminent, (which could hold back the speed of economic recovery).

- The **Financial Policy Committee** (FPC) report on 6.8.20 revised down their expected credit losses for the banking sector to “somewhat less than £80bn”. It stated that in its assessment, “banks have buffers of capital more than sufficient to absorb the losses that are likely to arise under the MPC’s central projection”. The FPC stated that for real stress in the sector, the economic output would need to be twice as bad as the MPC’s projection, with unemployment rising to above 15%.

- **US.** The Democrats gained the presidency and a majority in the House of Representatives in the November elections: after winning two key Senate seats in Georgia in elections in early January, they now also have a very slim majority in the Senate due to the vice president’s casting vote. President Biden will consequently have a much easier path to implement his election manifesto. However, he will not have a completely free hand as more radical Democrat plans may not be supported by all Democrat senators. His initial radical plan for a fiscal stimulus of $1.9trn, (9% of GDP), is therefore likely to be toned down in order to get through both houses.

- **The economy** had been recovering quite strongly from its contraction in 2020 of 10.2% due to the pandemic with GDP only 3.5% below its pre-pandemic level and the unemployment rate dropping below 7%. However, the rise in new cases during quarter 4, to the highest level since mid-August, suggests that the US could be in the early stages of a fourth wave. The latest upturn poses a threat that the recovery in the economy could stall. This is **the single biggest downside risk** to the shorter term outlook – a more widespread and severe wave of infections over the winter months, which is compounded by the impact of the regular flu season and, as a consequence, threatens to overwhelm health care facilities. Under those circumstances, individual states might feel it necessary to return to more draconian lockdowns.

- The restrictions imposed to control the spread of the virus are once again weighing on the economy with employment growth slowing sharply in November and declining in December, and retail sales dropping back. The economy is set for further weakness into the spring. **GDP growth** is expected to rebound markedly from the second quarter of 2021 onwards as vaccines are rolled out on a widespread basis and restrictions are loosened.

- After Chair Jerome Powell unveiled the **Fed's adoption of a flexible average inflation target** in his Jackson Hole speech in late August 2020, the mid-September meeting of the Fed agreed by a majority to a toned down version of the new inflation target in his speech - that *"it would likely be appropriate to maintain the current target range until labour market conditions were judged to be consistent with the Committee's assessments of maximum employment and inflation had risen to 2% and was on track to moderately exceed 2% for some time."* This change was aimed to provide more stimulus for economic growth and higher levels of employment and to avoid the danger of getting caught in a deflationary “trap” like Japan. It is to be noted that inflation has actually been under-shooting the 2% target significantly for most of the last decade, (and this year), so financial markets took note that higher levels of inflation are likely to be in the pipeline; long-term bond yields duly rose after the meeting. The FOMC’s updated economic and rate projections in mid-September showed that officials expect to leave the fed funds rate at near-zero until at least end-2023 and probably for another year or two beyond that. There is now some expectation that where the Fed has led in changing its inflation target, other major central banks will follow. The increase in tension over the last year between the US and China is likely to lead to a lack of momentum in progressing the initial positive moves to agree a phase one trade deal.

- The Fed's meeting on **5 November** was unremarkable - but at a politically sensitive time around the elections. At its **16 December** meeting the Fed tweaked the guidance for its monthly asset quantitative easing purchases with the new language implying those purchases could continue for longer than previously believed. Nevertheless, with officials still projecting that **inflation** will only get back to 2.0% in 2023, the vast majority expect the Fed funds rate to be still at near-zero until 2024 or later. Furthermore, officials think the balance of risks surrounding that median inflation forecast are firmly skewed to the downside. The key message is still that policy will remain unusually accommodative – with near-zero rates and asset purchases – continuing for several more years. This is likely to result in keeping Treasury yields low – which will also have an influence on gilt yields in this country.

- **EU.** In early December, the figures for Q3 GDP confirmed that the economy staged a rapid rebound from the first lockdowns. This provides grounds for optimism about growth prospects for next year. In Q2, GDP was 15% below its pre-pandemic level. But in Q3 the economy grew by 12.5% q/q leaving GDP down by "only" 4.4%. That was much better than had been expected earlier in the year. However, growth is likely to stagnate during Q4 and in Q1 of 2021, as a second wave of the virus has seriously affected many countries. The €750bn fiscal support package eventually agreed by the EU after prolonged disagreement between various countries, is unlikely to provide significant support, and quickly enough, to make an appreciable difference in the countries most affected by the first wave.

- With **inflation** expected to be unlikely to get much above 1% over the next two years, **the ECB** has been struggling to get inflation up to its 2% target. It is currently unlikely that it will cut its central rate even further into negative territory from -0.5%, although the ECB has stated that it retains this as a possible tool to use. The ECB's December meeting added a further €500bn to the PEPP scheme, (purchase of government and other bonds), and extended the duration of the programme to March 2022 and re-investing maturities for an additional year until December 2023. Three additional tranches of TLTRO, (cheap loans to banks), were approved, indicating that support will last beyond the impact of the pandemic, implying indirect yield curve control for government bonds for some time ahead. The Bank's forecast for a return to pre-virus activity levels was pushed back to the end of 2021, but stronger growth is projected in 2022. The total PEPP scheme of €1,850bn of QE which started in March 2020 is providing protection to the sovereign bond yields of weaker countries like Italy. There is therefore unlikely to be a euro crisis while the ECB is able to maintain this level of support. However, as in the UK and the US, the advent of highly effective vaccines will be a game changer, although growth will struggle before later in quarter 2 of 2021.

- **China.** After a concerted effort to get on top of the virus outbreak in Q1, economic recovery was strong in Q2 and then into Q3 and Q4; this has enabled China to recover all of the contraction in Q1. Policy makers have both quashed the virus and implemented a programme of monetary and fiscal support that has been particularly effective at stimulating short-term growth. At the same time, China's economy has benefited from the shift towards online spending by consumers in developed markets. These factors help to explain its comparative outperformance compared to western economies. However, this was achieved by major central government funding of yet more infrastructure spending. After years of growth having been focused on this same area, any further spending in this area is likely to lead to increasingly weaker economic returns in the longer term. This could, therefore, lead to a further misallocation of resources which will weigh on growth in future years.

- **Japan.** A third round of fiscal stimulus in early December took total fresh fiscal spending this year in response to the virus close to 12% of pre-virus GDP. That's huge by past standards, and one of the largest national fiscal responses. The budget deficit is now likely to reach 16% of GDP this year. Coupled with Japan's relative success in containing the virus without draconian measures so far, and the likelihood of effective vaccines being available in the coming months, the government's latest fiscal effort should help ensure a strong recovery and to get back to pre-virus levels by Q3 2021 – around the same time as the US and much sooner than the Eurozone.

- **World growth.** World growth will has been in recession in 2020 and this is likely to continue into the first half of 2021 before recovery in the second half. Inflation is unlikely to be a problem for some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.

- Until recent years, world growth has been boosted by increasing **globalisation** i.e. countries specialising in producing goods and commodities in which they have an economic advantage and which they then trade with the rest of the world. This has boosted worldwide productivity and growth, and, by lowering costs, has also depressed inflation. However, the rise of China as an economic superpower over the last thirty years, which now accounts for nearly 20% of total world GDP, has unbalanced the world economy. The Chinese government has targeted achieving major world positions in specific key sectors and products, especially high tech areas and production of rare earth minerals used in high tech products. It is achieving this by massive financial support, (i.e. subsidies), to state owned firms, government directions to other firms, technology theft, restrictions on market access by foreign firms and informal targets for the domestic market share of Chinese producers in the selected sectors. This is regarded as being unfair competition that is putting western firms at an unfair disadvantage or even putting some out of business. It is also regarded with suspicion on the political front as China is an authoritarian country that is not averse to using economic and military power for political advantage. The current trade war between the US and China therefore needs to be seen against that backdrop. It is, therefore, likely that we are heading into a period where there will be a **reversal of world globalisation and a decoupling of western countries** from dependence on China to supply products. This is likely to produce a backdrop in the coming years of weak global growth and so weak inflation.

Summary

Central banks are, therefore, likely to support growth by maintaining loose monetary policy through keeping rates very low for longer. Governments could also help a quicker recovery by providing more fiscal support for their economies at a time when total debt is affordable due to the very low rates of interest. They will also need to avoid significant increases in taxation or austerity measures that depress demand and the pace of recovery in their economies.

If there is a huge surge in investor confidence as a result of successful vaccines which leads to a major switch out of government bonds into equities, which, in turn, causes government debt yields to rise, then there will be pressure on central banks to actively manage debt yields by further QE purchases of government debt; this would help to suppress the rise in debt yields and so keep the total interest bill on greatly expanded government debt portfolios within manageable parameters. It is also the main alternative to a programme of austerity.

INTEREST RATE FORECASTS

Brexit. The interest rate forecasts provided by Link in paragraph 3.3 were predicated on an assumption of a reasonable agreement being reached on trade negotiations between the UK and the EU by 31.12.20. There is therefore no need to revise these forecasts now that a trade deal has been agreed. Brexit may reduce the economy's potential growth rate in the long run. However, much of that drag is now likely to be offset by an acceleration of productivity growth triggered by the digital revolution brought about by the COVID crisis.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably now skewed to the upside, but is still subject to some uncertainty due to the virus and the effect of any mutations, and how quick vaccines are in enabling a relaxation of restrictions.
- There is relatively little UK domestic risk of increases or decreases in Bank Rate and significant changes in shorter term PWLB rates. The Bank of England has effectively ruled out the use of negative interest rates in the near term and increases in Bank Rate are likely to be some years away given the underlying economic expectations. However, it is always possible that safe haven flows, due to unexpected domestic developments and those in other major economies, could impact gilt yields, (and so PWLB rates), in the UK.

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

- **UK government** takes too much action too quickly to raise taxation or introduce austerity measures that depress demand and the pace of recovery of the economy.
- **UK - Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis.** The ECB has taken monetary policy action to support the bonds of EU states, with the positive impact most likely for "weaker" countries. In addition, the EU agreed a €750bn fiscal support package. These actions will help shield weaker economic regions for the next two or three years. However, in the case of Italy, the cost of the virus crisis has added to its already huge debt mountain and its slow economic growth will leave it vulnerable to markets returning to taking the view that its level of debt is unsupportable. There remains a sharp divide between northern EU countries favouring low debt to GDP and annual balanced budgets and southern countries who want to see jointly issued Eurobonds to finance economic recovery. This divide could undermine the unity of the EU in time to come.
- Weak capitalisation of some **European banks**, which could be undermined further depending on extent of credit losses resultant of the pandemic.
- **German minority government & general election in 2021.** In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. Angela Merkel has stepped down from being the CDU party leader but she will remain as Chancellor until the general election in 2021. This then leaves a major question mark over who will be the major guiding hand and driver of EU unity when she steps down.
- **Other minority EU governments.** Italy, Spain, Austria, Sweden, Portugal, Netherlands, Ireland and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Austria, the Czech Republic, Poland and Hungary** now form a strongly anti-immigration bloc within the EU, and they had threatened to derail the 7 year EU budget until a compromise was thrashed out in late 2020. There has also been a rise in anti-immigration sentiment in Germany and France.
- **Geopolitical risks,** for example in China, Iran or North Korea, but also in Europe and other Middle Eastern countries, which could lead to increasing safe haven flows.

Upside risks to current forecasts for UK gilt yields and PWLB rates

- **UK -** a significant rise in inflationary pressures e.g. caused by a stronger than currently expected recovery in the UK economy after effective vaccines are administered quickly to the UK population, leading to a rapid resumption of normal life and return to full economic activity across all sectors of the economy.

- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a rapid series of increases in Bank Rate to stifle inflation.

5.2 APPENDIX: Treasury Management Practice (TMP1): Permitted Investments

This Council is asked to approve the following forms of investment instrument for use as permitted investments as set out in tables 1.1-1.4.

Treasury risks

All the investment instruments in tables 1.1-1.4 are subject to the following risks:-

1. **Credit and counter-party risk:** this is the risk of failure by a counterparty (bank or building society) to meet its contractual obligations to the organisation particularly as a result of the counterparty's diminished creditworthiness, and the resulting detrimental effect on the organisation's capital or current (revenue) resources. There are no counterparties where this risk is zero although AAA rated organisations have the highest, relative, level of creditworthiness.

2. **Liquidity risk:** this is the risk that cash will not be available when it is needed. While it could be said that all counterparties are subject to at least a very small level of liquidity risk as credit risk can never be zero, in this document, liquidity risk has been treated as whether or not instant access to cash can be obtained from each form of investment instrument. However, it has to be pointed out that while some forms of investment e.g. gilts, CDs, corporate bonds can usually be sold immediately if the need arises, there are two caveats: - a. cash may not be available until a settlement date up to three days after the sale b. there is an implied assumption that markets will not freeze up and so the instrument in question will find a ready buyer. The column in tables 1.1-1.4 headed as 'market risk' will show each investment instrument as being instant access, sale T+3 = transaction date plus 3 business days before you get cash, or term i.e. money is locked in until an agreed maturity date.

3. **Market risk:** this is the risk that, through adverse market fluctuations in the value of the principal sums an organisation borrows and invests, its stated treasury management policies and objectives are compromised, against which effects it has failed to protect itself adequately. However, some cash rich local authorities may positively want exposure to market risk e.g. those investing in investment instruments with a view to obtaining a long term increase in value.

4. **Interest rate risk**: this is the risk that fluctuations in the levels of interest rates create an unexpected or unbudgeted burden on the organisation's finances, against which the organisation has failed to protect itself adequately. This authority has set limits for its fixed and variable rate exposure in its Treasury Indicators in this report (see Section 3.4).

5. **Legal and regulatory risk:** this is the risk that the organisation itself, or an organisation with which it is dealing in its treasury management activities, fails to act in accordance with its legal powers or regulatory requirements, and that the organisation suffers losses accordingly.

Controls on treasury risks

1. **Credit and counter-party risk:** this authority has set minimum credit criteria to determine which counterparties and countries are of sufficiently high creditworthiness to be considered for investment purposes. See Sections 4.2 and 4.3.

2. **Liquidity risk:** this authority has a cash flow forecasting model to enable it to determine how long investments can be made for and how much can be invested.

3. **Market risk:** this authority does not purchase investment instruments which are subject to market risk in terms of fluctuation in their value.

4. **Interest rate risk**: this authority manages this risk by having a view of the future course of interest rates and then formulating a treasury management strategy accordingly which aims to maximise investment earnings consistent with control of risk or alternatively, seeks to minimise expenditure on interest costs on borrowing. See Section 4.4.

5. **Legal and regulatory risk:** this authority will not undertake any form of investing until it has ensured that it has all necessary powers and also complied with all regulations.

Unlimited investments

Regulation 24 states that an investment can be shown in tables 1 / 2 as being 'unlimited' in terms of the maximum amount or percentage of the total portfolio that can be put into that type of investment. However, it also requires that an explanation must be given for using that category. The authority has given the following types of investment an unlimited category: -

1. **Debt Management Agency Deposit Facility**. This is considered to be the lowest risk form of investment available to local authorities as it is operated by the Debt Management Office which is part of H.M. Treasury i.e. the UK Government's sovereign rating stands behind the DMADF. It is also a deposit account and avoids the complications of buying and holding Government issued treasury bills or gilts.

2. **High credit worthiness banks and building societies**. See paragraph 4.2 for an explanation of this authority's definition of high credit worthiness. While an unlimited amount of the investment portfolio may be put into banks and building societies with high credit worthiness, the authority will ensure diversification of its portfolio ensuring that no more than £15 million can be placed with any one institution or group at any one time, other than the Bank of Scotland or Royal Bank of Scotland where the limit is £30 million.

Objectives of each type of investment instrument

Regulation 25 requires an explanation of the objectives of every type of investment instrument which an authority approves as being 'permitted'.

1. DEPOSITS

The following forms of 'investments' are actually more accurately called deposits as cash is deposited in an account until an agreed maturity date or is held at call.

a) **Debt Management Agency Deposit Facility.** This offers the lowest risk form of investment available to local authorities as it is effectively an investment placed with the Government. It is also easy to use as it is a deposit account and avoids the complications of buying and holding Government issued treasury bills or gilts. As it is low risk it also earns low rates of interest. However, it is very useful for authorities whose overriding priority is the avoidance of risk. The longest period for a term deposit with the DMADF is 6 months.

b) **Term Deposits – Local Authorities.** They are quasi-Government bodies with low counterparty and value risk. Typical deposit terms vary from 1 month to 2 years, with longer term deposits offering an opportunity to increase investment returns by locking in high rates ahead of an expected fall in the level of interest rates. At other times, longer term rates can offer good value when the markets incorrectly assess the speed and timing of interest rate increases. This form of investing therefore, offers a lot of flexibility and typically higher earnings than the DMADF. Where it is restricted is that once a longer term investment is made, that cash is locked in until the maturity date other than with agreement of the counterparty, at which point penalties would typically apply.

c) **Call accounts with high credit worthiness banks and building societies.** See Section 4.2 for an explanation of this authority's definition of high credit worthiness. These typically offer a much higher rate of return than the DMADF and now that measures have been put in place to avoid over reliance on credit ratings, the authority feels much more confident that the residual risks around using such banks and building societies are at a low, reasonable and acceptable level. There is instant access to recalling cash deposited (or short-dated notice e.g. 15-30 days). This generally means accepting a lower rate of interest than that which could be earned from the same institution by making a term deposit (see 1d below). However, there are a number of call accounts which at the time of writing, offer rates 2 – 3 times more than term deposits with the DMADF. Some use of call accounts is highly desirable to ensure that the authority has ready access to cash when needed to pay bills.

d) **Term deposits with high credit worthiness banks and building societies.** The objectives are as for 1c. These offer a much higher rate of return than the DMADF and deposits made with other Local Authorities (dependent upon term) and, similar to 1c, now that measures have been put in place to avoid over reliance on credit ratings, the authority feels much more confident that the residual risks around using such banks and building societies are at a low, reasonable and acceptable level. This is the most widely used form of investing used by local authorities. The authority will ensure diversification of its portfolio of deposits ensuring that no more than £15 million is invested with any (non-nationalised) UK counterparty, and no more than £15 million is invested with any other non-UK counterparty, group or country. In addition, longer term deposits offer an opportunity to increase investment returns by locking in high rates ahead of an expected fall in the level of interest rates. At other times, longer term rates can offer good value when the markets incorrectly assess the speed and timing of interest rate increases. This form of investing therefore, offers a lot of flexibility and higher earnings than the DMADF. Where it is restricted is that once a longer term investment is made, that cash is locked in until the maturity date.

e) Fixed term deposits with variable rate and variable maturities (structured deposits). This encompasses ALL types of structured deposits. There has been considerable change in the types of structured deposits brought to the market over the last few years, some of which are already no longer available. In view of the fluidity of this area, this is a generic title for all structured deposits so as to provide councils with greater flexibility to adopt new instruments as and when they are brought to the market. This line encompasses ALL types of structured deposits. There has been considerable change in the types of structured deposits brought to the market over the last few years, some of which are already no longer available. In view of the fluidity of this area, this is a generic title for all structured deposits so as to provide greater flexibility to adopt new instruments as and when they are brought to the market.

2. DEPOSITS WITH COUNTERPARTIES CURRENTLY IN RECEIPT OF UK GOVERNMENT SUPPORT / OWNERSHIP

These banks offer another dimension of creditworthiness in terms of UK Government backing through either direct (partial or full) ownership. The view of this authority is that such backing makes these banks attractive institutions with whom to place deposits, and that will remain our view if the UK sovereign rating were to be downgraded in the coming year.

a. **Call accounts.** As for 1c. but UK Government stated support implies that the UK Government stands behind these banks and building societies and will be deeply committed to providing whatever support that may be required to ensure the continuity of such institutions. This authority feels this indicates a low and acceptable level of residual risk.

b. **Term deposits with high credit worthiness banks which are fully or semi nationalised.** As for 1d. but Government ownership partial or full implies that the UK Government stands behind this bank and will be deeply committed to providing whatever support that may be required to ensure the continuity of that bank. This authority considers this indicates a low and acceptable level of residual risk.

c. **Fixed term deposits with variable rate and variable maturities (structured deposits).** As for 1e but UK Government stated support implies that the UK Government stands behind eligible banks and building societies and will be deeply committed to providing whatever support that may be required to ensure the continuity of such institutions. This authority feels this indicates a low and acceptable level of residual risk. This line encompasses ALL types of structured deposits. There has been considerable change in the types of structured deposits brought to the market over the last few years, some of which are already no longer available. In view of the fluidity of this area, this is a generic title for all structured deposits so as to provide greater flexibility to adopt new instruments as and when they are brought to the market.

3. COLLECTIVE INVESTMENT SCHEMES STRUCTURED AS OPEN ENDED INVESTMENT COMPANIES (OEICS)

a. **Government liquidity funds.** These are the same as money market funds (see below) but only invest in government debt issuance with highly rated governments. Due to the higher quality of underlying investments, they offer a lower rate of return than MMFs. However, their net return is typically on a par with the DMADF, but with instant access.

b. **Money Market Funds (MMFs).** By definition, MMFs are AAA rated and are widely diversified, using many forms of money market securities including types which this authority does not currently have the expertise or capabilities to hold directly. However, due to the high level of expertise of the fund managers and the huge amounts of money invested in MMFs, and the fact that the weighted average maturity (WAM) cannot exceed 60 days, MMFs offer a combination of high security, instant access to funds, high diversification and good rates of return compared to equivalent instant access facilities. They are particularly advantageous in falling interest rate environments as their 60 day WAM means they have locked in investments earning higher rates of interest than are currently available in the market. MMFs also help an authority to diversify its own portfolio as e.g. a £2m investment placed directly with HSBC is a 100% risk exposure to HSBC whereas £2m invested in a MMF may end up with say £10,000 being invested with HSBC through the MMF. For authorities particularly concerned with risk exposure to banks, MMFs offer an effective way of minimising risk exposure while still getting much better rates of return than available through the DMADF.

c. **Ultra Short Dated Bond Funds .** These funds are similar to MMFs, can still be AAA rated but have Variable Net Asset Values (VNAV) as opposed to a traditional MMF which has a Constant Net Asset Value (CNAV). They aim to achieve a higher yield and to do this either take more credit risk or invest out for longer periods of time, which means they are more volatile. These funds can have WAM's and Weighted Average Life (WAL's) of 90 – 365 days or even longer. Their primary objective is yield and capital preservation is second. They therefore are a higher risk than MMFs and correspondingly have the potential to earn higher returns than MMFs.

d. **Gilt funds.** These are funds which invest only in U.K. Government gilts. They offer a lower rate of return than bond funds but are highly rated both as a fund and through investing only in highly rated government securities. They offer a higher rate of return than investing in the DMADF but they do have an exposure to movements in market prices of assets held.

e. **Bond funds.** These can invest in both government and corporate bonds. This therefore entails a higher level of risk exposure than gilt funds and the aim is to achieve a higher rate of return than normally available from gilt funds by trading in non-government bonds.

4. SECURITIES ISSUED OR GUARANTEED BY GOVERNMENTS

The following types of investments are where an authority directly purchases a particular investment instrument, a security, i.e. it has a market price when purchased and that value can change during the period the instrument is held until it matures or is sold. The annual earnings on a security is called a yield i.e. it is normally the interest paid by the issuer divided by the price you paid to purchase the security unless a security is initially issued at a discount e.g. treasury bills..

a. **Treasury bills.** These are short term bills (up to 12 months, although none have ever been issued for this maturity) issued by the Government and so are backed by the sovereign rating of the UK. The yield is higher than the rate of interest paid by the DMADF and another advantage compared to a time deposit in the DMADF is that they can be sold if there is a need for access to cash at any point in time. However, there is a spread between purchase and sale prices so early sales could incur a net cost during the period of ownership.

b. **Gilts.** These are longer term debt issuance by the UK Government and are backed by the sovereign rating of the UK. The yield is higher than the rate of interest paid by the DMADF and another advantage compared to a time deposit in the DMADF is that they can be sold if there is a need for access to cash at any point in time. However, there is a spread between purchase and sale prices so early sales may incur a net cost. Market movements that occur between purchase and sale may also have an adverse impact on proceeds. The advantage over Treasury bills is that they generally offer higher yields the longer it is to maturity (for most periods) if the yield curve is positive.

c. **Bond issuance issued by a financial institution which is explicitly guaranteed by the UK Government** e.g. National Rail. This is similar to a gilt due to the explicit Government guarantee.

d. **Sovereign bond issues (other than the UK govt) denominated in Sterling.** As for gilts but issued by other nations. Use limited to issues of nations with at least the same sovereign rating as for the UK.

e. **Bonds issued by Multi Lateral Development Banks (MLDBs).** These are similar to c. and e. above but are issued by MLDBs which are typically guaranteed by a group of sovereign states e.g. European Bank for Reconstruction and Development.

5. SECURITIES ISSUED BY CORPORATE ORGANISATIONS

The following types of investments are where an authority directly purchases a particular investment instrument, a security, i.e. it has a market price when purchased and that value can change during the period the instrument is held until it is sold. The annual earnings on a security is called a yield i.e. is the interest paid by the issuer divided by the price you paid to purchase the security. These are similar to the previous category but corporate organisations can have a wide variety of credit worthiness so it is essential for local authorities to only select the organisations with the highest levels of credit worthiness. Corporate securities are generally a higher risk than government debt issuance and so earn higher yields.

a. **Certificates of deposit (CDs).** These are shorter term securities issued by deposit taking institutions (mainly financial institutions). They are negotiable instruments, so can be sold ahead of maturity and also purchased after they have been issued. However, that liquidity can come at a price, where the yield could be marginally less than placing a deposit with the same bank as the issuing bank.

b. **Commercial paper.** This is similar to CDs but is issued by commercial organisations or other entities. Maturity periods are up to 365 days but commonly 90 days.

c. **Corporate bonds.** These are (long term) bonds (usually bearing a fixed rate of interest) issued by a financial institution, company or other non-government issuer in order to raise capital for the institution as an alternative to issuing shares or borrowing from banks. They are generally seen to be of a lower creditworthiness than government issued debt and so usually offer higher rates of yield.

d. **Floating rate notes.** These are bonds on which the rate of interest is established periodically with reference to short-term interest rates.

6. OTHER

a. Local Authority Mortgage Scheme. Authorities who are participating in the Local Authority Mortgage Guarantee Scheme (LAMS) may be required to place a deposit with the mortgage provider(s) up to the full value of the guarantee. The deposit will be in place for the term of the guarantee i.e. 5 years (with the possibility of a further 2 year extension if the account is 90+ days in arrears at the end of the initial 5 years) - and may have conditions / structures attached. The mortgage provider will not hold a legal charge over the deposit.

b. Loans to third parties – This would involve the Council borrowing from the PWLB/markets and onward lending to Registered Social Landlords to enable them to access lower cost loans and kickstart developments of affordable mid-market homes. The risk associated with such an investment would be mitigated by an assessment of the counterparty in advance of any loan being granted and through the application of a premium on the loan rate. Interest would be paid by the RSL over the term of the loan, with repayment of principal upon the earlier of 10/20 years or at the point of house sales. The Council will also request that a standard security is taken over the property which would allow the Council to require the sale of the homes to another landlord, providing greater risk mitigation.

c. **Subordinated Debt Subscription to the SPV set up to deliver the Newbattle Centre project –** this involved the Council subscribing £332,806 of subordinated debt to the SPV that was set up to deliver the Newbattle Centre project (2 year construction and 25 year operational contract length). The length of the investment is 25 years with the subscription made at operation commencement of the contract. The repayment profile will comprise 81% of the principal remaining invested until the final two years of the contract. The risk associated with this type of investment will be mitigated through an annual assessment as a minimum to review the holding of such debt, and whether the exposure to risk arising from the investment has changed over the period.

d. **Property fund.** This is a collective investment fund specialising in property. Rather than owning a single property with all the risk exposure that means to one property in one location rising or falling in value, maintenance costs, tenants actually paying their rent / lease etc, a collective fund offers the advantage of diversified investment over a wide portfolio of different properties. This can be attractive for authorities who want exposure to the potential for the property sector to rise in value. However, timing is critical to entering or leaving this sector at the optimum times of the property cycle of rising and falling values. Typically, the minimum investment time horizon for considering such funds is at least 3-5 years.

e. **ESCO:** Joint Venture with Vattenfall to deliver energy supply to Shawfair using heat supplied form the Energy from Waste plant and related projects.

Table 1: Permitted Investments

1.1 Deposits

Investment Category	Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period	Max Transaction Value
Debt Management Agency Deposit Facility	UK Government	Term	No	**100%**	**6 months**	**£30m**
Term deposits – local authorities	Quasi-UK Government	Term	No	**100%**	**5 years**	**£15m**
Call accounts – banks and building societies	Green	Instant	No	**100%**	**1 day**	**£15m**
Term deposits / Notice Accounts – banks and building societies	Yellow Purple Blue Orange Red Green No Colour	Term	No	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 8 mths** **Up to 120 days** **Not for use**	**£15m**
Fixed term deposits with variable rate and variable maturities: - Structured deposits	Yellow Purple Blue Orange Red Green No Colour	Term	No	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 8 mths** **Up to 120 days** **Not for use**	**£15m**

1.2 Deposits with counterparties currently in receipt of government support / ownership

Investment Category	Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period	Max Transaction Value
UK nationalised banks – Call accounts	Blue	Instant	No	**100%**	**1 day**	**£30m**
UK nationalised banks – Term Deposits / Notice Accounts	Blue	Term	No	**100%**	**2 years**	**£30m**
UK nationalised banks – Fixed term deposits with variable rate and variable maturities: - Structured deposits	Blue	Term	No	**100%**	**2 years**	**£30m**
Non-UK (high sovereign rated country) nationalised banks – Call accounts	Green	Instant	No	**100%**	**1 day**	**£15m**
Non-UK (high sovereign rated country) nationalised banks:- Term Deposits / Notice Accounts	Yellow Purple Blue Orange Red Green No Colour	Term	No	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 8 mths** **Up to 120 days** **Not for use**	**£15m**
Non-UK (high sovereign rated country) nationalised banks:- Fixed term deposits with variable rate and variable maturities: - Structured deposits	Yellow Purple Blue Orange Red Green No Colour	Term	No	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 8 mths** **Up to 120 days** **Not for use**	**£15m**

If forward deposits are made, the forward period plus the deal period equate to the maximum maturity period.

1.3 Collective investment schemes structured as Open Ended Investment Companies (OEICs)

Investment Category	Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period	Max Transaction Value
Government Liquidity Funds	AAA	Instant	No	**100%**	**1 day**	**£15m**
Money Market Funds CNAV	AAA	Instant	No	**100%**	**1 day**	**£15m**
Money Market Funds LVNAV	AAA	Instant	No	**100%**	**1 day**	**£15m**
Money Market Funds VNAV	AAA	Instant	No	**100%**	**1 day**	**£15m**
Ultra Short Dated Bond Funds with a credit score of 1.25	AAA	T+1 to T+5	Yes	**100%**	**1 day**	**£15m**
Ultra Short Dated Bond Funds with a credit score of 1.5	AAA	T+1 to T+5	Yes	**100%**	**1 week**	**£15m**
Bond Funds	AAA	T+2 or longer	Yes	**50%**	**2 days**	**£15m**
Gilt Funds	AAA	T+2 or longer	Yes	**50%**	**2 days**	**£15m**

1.4 Securities issued or guaranteed by governments

Investment Category	* Minimum Credit Criteria	Liquidity risk	Market risk	Max %?£m of total investments	Max. maturity period
Treasury Bills	UK sovereign rating	Sale T+1	Yes	**100%**	**6 months**
UK Government Gilts	UK sovereign rating	Sale T+1	Yes	**100%**	**50 years**
Bond issuance issued by a financial institution which is explicitly guaranteed by the UK Government e.g. National Rail	UK sovereign rating	Sale T+3	Yes	**100%**	**50 years**
Sovereign bond issues (other than the UK govt)	AAA (or state your criteria if different)	Sale T+1	Yes	**100%**	**50 years**
Bonds issued by multilateral development banks	AAA (or state your criteria if different)	Sale T+1	Yes	**100%**	**50 years**

1.5 Securities issued by corporate organisations

Investment Category	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period	Max Transaction Value
Certificates of deposit issued by banks and building societies	Yellow Purple Blue Orange Red Green No Colour	Sale T+1	Yes	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 8 mths** **Up to 100 days** **Not for use**	**£15m**
Commercial paper other	Yellow Purple Blue Orange Red Green No Colour	Sale T+0	Yes	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 8 mths** **Up to 100 days** **Not for use**	**£15m**
Floating rate notes	Yellow Purple Blue Orange Red Green No Colour	Sale T+2	Yes	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 8 mths** **Up to 100 days** **Not for use**	**£15m**
Corporate Bonds other	Yellow Purple Blue Orange Red Green No Colour	Sale T+2	Yes	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 8 mths** **Up to 100 days** **Not for use**	**£15m**

1.6 Other

Investment Category	Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period
Local authority mortgage guarantee scheme.	Blue	Term	No	**50%**	**5 years**
Loans to Third Parties	n/a	Term	No	**£25m**	**20 years**
Subordinated Debt Subscription to Newbattle Centre SPV	n/a	Term	No	**£0.333m**	**25 years**
Property Funds	n/a	T+4	Yes	**50%**	**15 years**
ESCO	n/a	Term	No	**£9m**	**n/a**

5.3 APPENDIX: Treasury Management Practice (TMP1) – Credit and Counterparty Risk Management

Midlothian Council Permitted Investments, Associated Controls and Limits

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits
Cash type instruments			
a. Deposits with the Debt Management Account Facility (UK Government) (**Very low risk)**	This is a deposit with the UK Government and as such counterparty and liquidity risk is very low, and there is no risk to value. Deposits can be between overnight and 6 months.	Little mitigating controls required. As this is a UK Government investment the monetary limit is unlimited to allow for a safe haven for investments.	As shown in Appendix 5.2.
b. Deposits with other local authorities or public bodies **(Very low risk)**	These are considered quasi UK Government debt and as such counterparty risk is very low, and there is no risk to value. Deposits can only be broken with the agreement of the counterparty, and penalties can apply. Deposits with other non-local authority bodies will be restricted to the overall credit rating criteria.	Little mitigating controls required for local authority deposits, as this is a quasi UK Government investment. Non- local authority deposits will follow the approved credit rating criteria.	As shown in Appendix 5.2.
c. CNAV, LVNAV and VNAV Money Market Funds (MMFs) **(Low to very low risk)**	Pooled cash investment vehicle which provides very low counterparty, liquidity and market risk. These will primarily be used as liquidity instruments.	Funds will only be used where the MMF has a “AAA” rated status from either Fitch, Moody’s or Standard & Poors.	As shown in Appendix 5.2.
d. Ultra Short Dated Bond Funds **(low risk)**	Pooled cash investment vehicle which provides very low counterparty, liquidity and market risk. These will primarily be used as liquidity instruments.	Funds will only be used where the Ultra Short Dated Bond Fund has a “AAA” rated status from either Fitch, Moody’s or Standard and Poor’s.	As shown in Appendix 5.2.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits
e. Call account deposit accounts with financial institutions (banks and building societies) **(Low risk depending on credit rating)**	These tend to be low risk investments, but will exhibit higher risks than categories (a), (b) and (c) above. Whilst there is no risk to value with these types of investments, liquidity is high and investments can be returned at short notice.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's, with the credit scoring methodology by Link asset Services overlaid. On day to day investment dealing with this criteria will be further strengthened by the use of additional market intelligence.	As shown in Appendix 5.2.
f. Term deposits with financial institutions (banks and building societies) **(Low to medium risk depending on period & credit rating)**	These tend to be low risk investments, but will exhibit higher risks than categories (a), (b), (c) and (d) above. Whilst there is no risk to value with these types of investments, liquidity is low and term deposits can only be broken with the agreement of the counterparty, and penalties may apply.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's, with the credit scoring methodology by Link asset Services overlaid. On day to day investment dealing, this criteria will be further strengthened by the use of additional market intelligence.	As shown in Appendix 5.2.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits
g. Government Gilts and Treasury Bills **(Very low risk)**	These are marketable securities issued by the UK Government and as such counterparty and liquidity risk is very low, although there is potential risk to value arising from an adverse movement in interest rates (no loss if these are held to maturity.	Little counterparty mitigating controls are required, as this is a UK Government investment. The potential for capital loss will be reduced by limiting the maximum monetary and time exposures	As shown in Appendix 5.2.
h. Certificates of deposits with financial institutions **(Low risk)**	These are short dated marketable securities issued by financial institutions and as such counterparty risk is low, but will exhibit higher risks than categories (a), (b) and (c) above. There is risk to value of capital loss arising from selling ahead of maturity if combined with an adverse movement in interest rates (no loss if these are held to maturity). Liquidity risk will normally be low.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's. The selection defaults to the lowest available colour band / credit rating to provide additional risk control measures. Day to day investment dealing with this criteria will be further strengthened by the use of additional market intelligence.	As shown in Appendix 5.2.
i. Structured deposit facilities with banks and building societies (escalating rates, de-escalating rates etc.) (Low to medium risk depending on period & credit rating)	These tend to be medium to low risk investments, but will exhibit higher risks than categories (a), (b), (c) and (d) above. Whilst there is no risk to value with these types of investments, liquidity is very low and investments can only be broken with the agreement of the counterparty (penalties may apply).	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's, with the credit scoring methodology by Link asset Services overlaid. On day to day investment dealing, this criteria will be further strengthened by the use of additional market intelligence.	As shown in Appendix 5.2.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits
j. Corporate bonds **(Medium to high risk depending on period & credit rating)**	These are marketable securities issued by financial and corporate institutions. Counterparty risk will vary and there is risk to value of capital loss arising from selling ahead of maturity if combined with an adverse movement in interest rates. Liquidity risk will be low.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's. The selection defaults to the lowest available colour band / credit rating to provide additional risk control measures. Corporate bonds will be restricted to those meeting the base criteria. Day to day investment dealing with this criteria will be further strengthened by the use of additional market intelligence.	As shown in Appendix 5.2.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits
Other types of investments			
k. Loans to third parties	Using the example of a loan to a RSL, these would be medium risk investments, exhibiting higher risks than categories (a)-(f) above. They are also highly illiquid and are only repaid at the end of a defined period of time (up to 20 years) or on the sale of a property, whichever is the earlier.	The risk associated with such an investment would be mitigated through the application of a premium on the loan rate. The Council will also request that a standard security is taken over the property which would allow the Council to require the sale of the homes to another landlord, providing greater risk mitigation.	£25m
l. Non-local authority shareholdings	These are non-service investments which may exhibit market risk, be only considered for longer term investments and will be likely to be liquid.	Any non-service equity investment will require separate Member approval and each application will be supported by the service rational behind the investment and the likelihood of loss.	Per Existing
m. Local Authority Mortgage Scheme (LAMS)	These are service investments at market rates of interest plus a premium.		As shown in Appendix 5.2.
n. Subordinated Debt Subscription to Newbattle Centre SPV	These are investments that are exposed to the success or failure of individual projects and are highly illiquid.	The Council and Scottish Government (via the SFT) are participants in and party to the governance and controls within the project structure. As such they are well placed to influence and ensure the successful completion of the project's term.	As shown in Appendix 5.2.
o. ESCO	These are investments that are exposed to the success or failure of individual projects and are highly illiquid.	The Council is in a joint venture partnership and therefore party to the governance and controls within the project structure. As such the Council is	As shown in Appendix 5.2.

		well placed to influence and ensure the successful completion of the project's term	

The Monitoring of Investment Counterparties - The status of counterparties will be monitored regularly. The Council receives credit rating and market information from Link asset Services, including when ratings change, and counterparties are checked promptly. On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the Chief Officer Corporate Solutions, and if required new counterparties which meet the criteria will be added to the list.

5.4 APPENDIX: Approved countries for investments

Based on the lowest available rating as at 03.01.2020

AAA

- Australia
- Denmark
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland

AA+

- Canada
- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)
- France

AA-

- Belgium
- Hong Kong
- Qatar
- U.K.

List correct as at 20.01.2021

5.5 APPENDIX: Treasury management scheme of delegation

(i) Full Council

- receiving and reviewing reports on treasury management policies, practices and activities;
- approval of annual strategy.
- approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices;
- budget consideration and approval;
- approval of the division of responsibilities;
- receiving and reviewing regular monitoring reports and acting on recommendations;
- approving the selection of external service providers and agreeing terms of appointment.

(iii) Audit Committee

- reviewing treasury management reports, the treasury management policy and procedures, and making recommendations to the responsible body.

5.6 APPENDIX: The treasury management role of the section 95 officer

The S95 (responsible) officer

- recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance;
- submitting regular treasury management policy reports;
- submitting budgets and budget variations;
- receiving and reviewing management information reports;
- reviewing the performance of the treasury management function;
- ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function;
- ensuring the adequacy of internal audit, and liaising with external audit;
- recommending the appointment of external service providers;
- preparation of a capital strategy to include capital expenditure, capital financing, non-financial investments and treasury management, with a long term timeframe;
- ensuring that the capital strategy is prudent, sustainable, affordable and prudent in the long term and provides value for money;
- ensuring that due diligence has been carried out on all treasury and non-financial investments and is in accordance with the risk appetite of the authority;
- ensure that the authority has appropriate legal powers to undertake expenditure on non-financial assets and their financing;
- ensuring the proportionality of all investments so that the authority does not undertake a level of investing which exposes the authority to an excessive level of risk compared to its financial resources;
- ensuring that an adequate governance process is in place for the approval, monitoring and ongoing risk management of all non-financial investments and long term liabilities;
- provision to members of a schedule of all non-treasury investments including material investments in subsidiaries, joint ventures, loans and financial guarantees ensuring that members are adequately informed and understand the risk exposures taken on by an authority;
- ensuring that the authority has adequate expertise, either in house or externally provided, to carry out the above;
- creation of Treasury Management Practices which specifically deal with how non-treasury investments will be carried out and managed, to include the following:-
    - Risk management (TMP1 and schedules), including investment and risk management criteria for any material non-treasury investment portfolios;
    - Performance measurement and management (TMP2 and schedules), including methodology and criteria for assessing the performance and success of non-treasury investments;
    - Decision making, governance and organisation (TMP5 and schedules), including a statement of the governance requirements for decision making in relation to non-treasury investments; and arrangements to ensure that appropriate professional due diligence is carried out to support decision making;
    - Reporting and management information (TMP6 and schedules), including where and how often monitoring reports are taken;

- Training and qualifications (TMP10 and schedules), including how the relevant knowledge and skills in relation to non-treasury investments will be arranged.