

Treasury Management Strategy Statement and Annual Investment Strategy

Midlothian Council
2018/19

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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.

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."

1.2 Reporting requirements

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

Prudential and treasury indicators and treasury strategy (this report) - The first, and most important report covers:

- the capital plans (including prudential indicators) for 2018/19 to 2022/23;
- the treasury management strategy (how the investments and borrowings are to be organised) for 2018/19, including treasury indicators; and
- an investment strategy for 2018/19 (the parameters on how investments are to be managed).

A mid year treasury management report – This will update members with the progress of the capital 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.

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 undertaken by the Audit Committee.

1.3 Treasury Management Strategy for 2018/19

The strategy for 2018/19 covers two main areas:

Capital issues

- the capital plans and the prudential indicators (Section 2 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 Scottish Government Investment Regulations.

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 responsible for scrutiny. A training workshop for Members was held on 14 June 2017 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 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.

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 2018/19 – 2022/23

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 | | | | | | |
|--------------------------------|-----------------------------|-------------------------------|-------------------------------|-------------------------------|-------------------------------|-------------------------------|
| | 2016/17 Actual £000's | 2017/18 Estimate £000's | 2018/19 Estimate £000's | 2019/20 Estimate £000's | 2020/21 Estimate £000's | 2021/22 Estimate £000's |
| General Services | | | | | | |
| Resources | £ 7,987 | £ 9,098 | £ 11,765 | £ 13,479 | £ 18,351 | £ 12,116 |
| Education, Community & Economy | £ 22,875 | £ 15,439 | £ 19,440 | £ 12,648 | £ 6,573 | £ 1,541 |
| Health & Social Care | £ 95 | £ 294 | £ 994 | £ 447 | £ 150 | £ 203 |
| Business Transformation | £ 189 | £ 85 | £ 3,877 | £ 5,923 | £ 2,100 | £ - |
| Unallocated | £ - | £ - | £ - | £ - | £ - | £ - |
| Total General Services | £ 31,146 | £ 24,916 | £ 36,076 | £ 32,497 | £ 27,174 | £ 13,860 |
| Total HRA | £ 23,907 | £ 12,722 | £ 40,785 | £ 53,960 | £ 54,634 | £ 52,678 |
| Combined Total | £ 55,053 | £ 37,638 | £ 76,861 | £ 86,457 | £ 81,808 | £ 66,538 |

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 | | | | | | |
|--|-----------------------------|-------------------------------|-------------------------------|-------------------------------|-------------------------------|-------------------------------|
| | 2016/17 Actual £000's | 2017/18 Estimate £000's | 2018/19 Estimate £000's | 2019/20 Estimate £000's | 2020/21 Estimate £000's | 2021/22 Estimate £000's |
| Capital Expenditure | | | | | | |
| General Services | £ 31,146 | £ 24,916 | £ 36,076 | £ 32,497 | £ 27,174 | £ 13,860 |
| HRA | £ 23,907 | £ 12,722 | £ 40,785 | £ 53,960 | £ 54,634 | £ 52,678 |
| Total | £ 55,053 | £ 37,638 | £ 76,861 | £ 86,457 | £ 81,808 | £ 66,538 |
| Financed by: | | | | | | |
| Capital receipts | £ 5,983 | £ 2,061 | £ - | £ - | £ - | £ - |
| Capital grants | £ 12,723 | £ 12,202 | £ 17,403 | £ 14,982 | £ 19,656 | £ 21,354 |
| Capital reserves | £ - | £ - | £ 3,900 | £ 6,000 | £ 2,100 | £ - |
| Developer/Other Contributions | £ 6,470 | £ 8,314 | £ 7,818 | £ 2,407 | £ 1,829 | £ 1,749 |
| Net financing need for the year | £ 29,877 | £ 15,061 | £ 47,740 | £ 63,068 | £ 58,223 | £ 43,435 |

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

2.2 Statutory repayment of loans fund advances

Under 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.

A variety of options are provided to Councils so long as a prudent provision is made each year. The Council is recommended to approve the following policy on the repayment of loans fund advances:-

- For loans fund advances made before 1 April 2016, the policy will be to maintain the practice of previous years and apply what is termed “the Statutory Method”, with all loans fund advances being repaid by the annuity method.
- For loans fund advances made after 1 April 2016, the policy for the repayment of loans advances is proposed to continue to operate under the “Statutory Method” – i.e. loans fund advances will be repaid by the annuity method. This annuity rate that is proposed to be applied to the loans fund repayments is based on current interest rates and is currently 3.10%.

A review of the Loans Fund accounting arrangements is currently being undertaken which includes an assessment of the period over which Loans Fund advances are projected to be repaid. At this time a savings target of £0.500 million has been attached to the review and reflected in the 2018/19 proposed budget with the final outcome of the review expected to be reflected in the both the revised Capital Strategy and Plan and the final outturn position for the current year which will be reported to Council in June 2018. In addition, any proposed change to the policy for the repayment of loans fund advances will be reported to Council for approval.

2.3 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 £56.2m of such schemes within the CFR. The Council is asked to approve the CFR projections below:

| Table 3: Capital Financing Requirement (CFR) | | | | | | |
|--|------------------|------------------|------------------|------------------|------------------|------------------|
| | 2016/17 | 2017/18 | 2018/19 | 2019/20 | 2020/21 | 2021/22 |
| | Actual | Estimate | Estimate | Estimate | Estimate | Estimate |
| | £000's | £000's | £000's | £000's | £000's | £000's |
| Capital Financing Requirement | | | | | | |
| CFR – General Services | £ 116,154 | £ 119,550 | £ 127,647 | £ 136,206 | £ 145,406 | £ 143,262 |
| CFR – HRA | £ 162,628 | £ 166,325 | £ 197,549 | £ 242,821 | £ 281,219 | £ 315,112 |
| CFR – PFI Schemes | £ 54,972 | £ 53,659 | £ 52,233 | £ 50,683 | £ 48,998 | £ 47,167 |
| Total CFR | £ 333,754 | £ 339,534 | £ 377,429 | £ 429,710 | £ 475,623 | £ 505,541 |
| Movement in CFR | £ 21,376 | £ 5,780 | £ 37,895 | £ 52,281 | £ 45,913 | £ 29,918 |
| Movement in CFR represented by | | | | | | |
| Net financing need for the year (previous table) | £ 29,877 | £ 15,061 | £ 47,740 | £ 63,068 | £ 58,223 | £ 43,435 |
| Less Scheduled Debt Amortisation | £ (7,293) | £ (7,968) | £ (8,419) | £ (9,237) | £ (10,625) | £ (11,686) |
| Less PFI Finance Lease Principal Payments | £ (1,208) | £ (1,313) | £ (1,426) | £ (1,550) | £ (1,685) | £ (1,831) |
| Movement in CFR | £ 21,376 | £ 5,780 | £ 37,895 | £ 52,281 | £ 45,913 | £ 29,918 |

2.4 Core funds and expected investment balances

The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc). Detailed below are estimates of the year end balances for each resource.

| Table 4: Balance Sheet Resources | | | | | | |
|------------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Reserve | 2016/17 | 2017/18 | 2018/19 | 2019/20 | 2020/21 | 2021/22 |
| | Actual | Estimate | Estimate | Estimate | Estimate | Estimate |
| | £000's | £000's | £000's | £000's | £000's | £000's |
| HRA Balances | £ 29,753 | £ 34,938 | £ 39,424 | £ 43,101 | £ 45,036 | £ 46,308 |
| General Fund Balances | £ 8,557 | £ 6,387 | £ 8,790 | £ 10,706 | £ 10,892 | £ 10,892 |
| Earmarked reserves | £ 9,094 | £ 4,779 | £ - | £ - | £ - | £ - |
| Provisions | £ 3,100 | £ 2,875 | £ 2,772 | £ 3,236 | £ 3,214 | £ 2,787 |
| Capital Fund | £ 16,707 | £ 17,957 | £ 20,861 | £ 25,166 | £ 23,066 | £ 23,066 |
| Total Reserves / Core Funds | £ 67,211 | £ 66,936 | £ 71,847 | £ 82,209 | £ 82,208 | £ 83,053 |

2.5 Affordability prudential indicators

The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. The Council is asked to approve the following indicators:-

2.6 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.

| Table 5: Ratio of Financing Costs to Net Revenue Stream | | | | | | | |
|---|---------------|---------------|----------|----------|----------|----------|----------|
| % | 2016/17 | 2016/17 | 2017/18 | 2018/19 | 2019/20 | 2020/21 | 2021/22 |
| | Original | Actual | Estimate | Estimate | Estimate | Estimate | Estimate |
| General Services | 3.57% | 3.58% | 3.78% | 3.87% | 3.94% | 4.26% | 4.47% |
| HRA | 34.35% | 34.59% | 34.14% | 34.39% | 37.33% | 43.06% | 45.77% |

The estimates of financing costs include current commitments and the proposals in this budget report.

2.7 HRA ratios

| Table 6: HRA Debt as a % of Gross Revenue | | | | | | |
|---|-----------|-----------|-----------|-----------|-----------|-----------|
| | 2016/17 | 2017/18 | 2018/19 | 2019/20 | 2020/21 | 2021/22 |
| | Actual | Estimate | Estimate | Estimate | Estimate | Estimate |
| HRA debt £000's | £ 162,628 | £ 166,325 | £ 197,549 | £ 242,821 | £ 281,219 | £ 315,112 |
| HRA revenues £000's | £ 24,657 | £ 26,399 | £ 27,993 | £ 30,089 | £ 31,991 | £ 34,508 |
| Ratio of debt to revenues % | 660% | 630% | 706% | 807% | 879% | 913% |

| Table 7: HRA Debt per Dwelling | | | | | | |
|--------------------------------|-----------|-----------|-----------|-----------|-----------|-----------|
| | 2016/17 | 2017/18 | 2018/19 | 2019/20 | 2020/21 | 2021/22 |
| | Actual | Estimate | Estimate | Estimate | Estimate | Estimate |
| HRA debt £000's | £ 162,628 | £ 166,325 | £ 197,549 | £ 242,821 | £ 281,219 | £ 315,112 |
| Number of HRA dwellings | 6,875 | 6,917 | 6,970 | 7,022 | 7,068 | 7,074 |
| Debt per dwelling £ | £ 23,655 | £ 24,046 | £ 28,343 | £ 34,580 | £ 39,788 | £ 44,545 |

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 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 appropriate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

3.1 Current portfolio position

The Council's treasury portfolio position at 31 March 2017, with forward projections 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.

| Table 8: Current Treasury Portfolio | | | | | | |
|---|------------------|------------------|------------------|------------------|------------------|------------------|
| | 2016/17 | 2017/18 | 2018/19 | 2019/20 | 2020/21 | 2021/22 |
| | Actual | Estimate | Estimate | Estimate | Estimate | Estimate |
| | £000's | £000's | £000's | £000's | £000's | £000's |
| External Debt | | | | | | |
| Debt at 1 April | £ 237,272 | £ 257,302 | £ 267,031 | £ 290,770 | £ 337,051 | £ 383,616 |
| Actual/Expected change in Debt | £ 20,030 | £ 9,729 | £ 23,739 | £ 46,281 | £ 46,565 | £ 29,101 |
| Other long-term liabilities (OLTL) at 1 April | £ 56,180 | £ 54,972 | £ 53,659 | £ 52,233 | £ 50,683 | £ 48,998 |
| Actual/Expected change in OLTL | £ (1,208) | £ (1,313) | £ (1,426) | £ (1,550) | £ (1,685) | £ (1,832) |
| Actual/Expected Gross Debt at 31 March | £ 312,274 | £ 320,690 | £ 343,003 | £ 387,734 | £ 432,614 | £ 459,883 |
| The Capital Financing Requirement | £ 333,754 | £ 339,534 | £ 377,429 | £ 429,710 | £ 475,623 | £ 505,541 |
| Under / (over) borrowing | £ 21,480 | £ 18,844 | £ 34,426 | £ 41,976 | £ 43,009 | £ 45,658 |
| | | | | | | |
| Investments | | | | | | |
| Cash & Cash Equivalents | £ 8,581 | £ 10,000 | £ 10,000 | £ 10,000 | £ 10,000 | £ 10,000 |
| Short-Term Investments | £ 74,985 | £ 64,985 | £ 64,985 | £ 64,985 | £ 64,985 | £ 64,985 |
| Total Investments | £ 83,566 | £ 74,985 | £ 74,985 | £ 74,985 | £ 74,985 | £ 74,985 |

Within the 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 2018/19 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

The Head of Finance & Integrated Service Support 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 next 5 financial years (2018/19 to 2022/23); 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.

| Table 9: Operational Boundary | | | | | | |
|--|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| | 2016/17 | 2017/18 | 2018/19 | 2019/20 | 2020/21 | 2021/22 |
| | Actual | Estimate | Estimate | Estimate | Estimate | Estimate |
| | £000's | £000's | £000's | £000's | £000's | £000's |
| Operational Boundary - Borrowing | £278,782 | £285,875 | £325,196 | £379,027 | £426,625 | £458,374 |
| Operational Boundary - Other long term liabilities | £ 54,972 | £ 53,659 | £ 52,233 | £ 50,683 | £ 48,998 | £ 47,167 |
| Total | £333,754 | £339,534 | £377,429 | £429,710 | £475,623 | £505,541 |

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 (2018/19 to 2021/22), 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 £285.875 million for 2017/18, £325.196 million for 2018/19, £379.027 million for 2019/20, £426.625 million for 2020/21 and £458.374 million for 2021/22, that permission be granted to borrow up to the 2021/22 Authorised Limit for borrowing of £482.021 million as shown in the table below), if market conditions support this action;
 - b. 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 2022 remains achievable.
 - c. 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 two PPP agreements.

| Table 10: Authorised Limit | | | | | | |
|--|------------------|------------------|------------------|------------------|------------------|------------------|
| | 2016/17 | 2017/18 | 2018/19 | 2019/20 | 2020/21 | 2021/22 |
| | Actual | Estimate | Estimate | Estimate | Estimate | Estimate |
| | £000's | £000's | £000's | £000's | £000's | £000's |
| Authorised Limit - Borrowing | £ 482,021 | £ 482,021 | £ 482,021 | £ 482,021 | £ 482,021 | £ 482,021 |
| Authorised Limit - Other long term liabilities | £ 54,972 | £ 53,659 | £ 52,233 | £ 50,683 | £ 48,998 | £ 47,167 |
| Total Debt | £ 536,993 | £ 535,680 | £ 534,254 | £ 532,704 | £ 531,019 | £ 529,188 |

| Table 11: Reconciliation of Authorised Limit for Borrowing | |
|--|------------------|
| | £000's |
| CFR - General Services at 31 March 2021 | £ 145,406 |
| CFR - HRA at 31 March 2022 | £ 315,112 |
| Capital Receipts 2017/18 unrealised to date | £ 2,076 |
| Capital Receipts 2018/19 to 2021/22 | £ - |
| Developer/Other Contributions 2017/18 Unrealised to date | £ 5,624 |
| Developer/Other Contributions 2018/19 to 2021/22 | £ 13,803 |
| Authorised Limit for Borrowing | £ 482,021 |

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 the Link asset Services central view.

| Table 12: Interest Rate Forecasts | | | | | |
|--|------------------|---|----------------|----------------|----------------|
| Quarterly Averages | | | | | |
| Quarter Ending | Bank Rate | PWLB Borrowing Rates | | | |
| | | (inc. certainty rate adjustment) | | | |
| | | 5 year | 10 year | 25 year | 50 year |
| Mar 2018 | 0.50% | 1.60% | 2.20% | 2.90% | 2.60% |
| Jun 2018 | 0.50% | 1.60% | 2.30% | 3.00% | 2.70% |
| Sep 2018 | 0.50% | 1.70% | 2.40% | 3.00% | 2.80% |
| Dec 2018 | 0.75% | 1.80% | 2.40% | 3.10% | 2.90% |
| Mar 2019 | 0.75% | 1.80% | 2.50% | 3.10% | 2.90% |
| Jun 2019 | 0.75% | 1.90% | 2.60% | 3.20% | 3.00% |
| Sep 2019 | 0.75% | 1.90% | 2.60% | 3.20% | 3.00% |
| Dec 2019 | 1.00% | 2.00% | 2.70% | 3.30% | 3.10% |
| Mar 2020 | 1.00% | 2.10% | 2.70% | 3.40% | 3.20% |
| Jun 2020 | 1.00% | 2.10% | 2.80% | 3.50% | 3.30% |
| Sep 2020 | 1.25% | 2.20% | 2.90% | 3.50% | 3.30% |
| Dec 2020 | 1.25% | 2.30% | 2.90% | 3.60% | 3.40% |
| Mar 2021 | 1.25% | 2.30% | 3.00% | 3.60% | 3.40% |

As expected, the Monetary Policy Committee (MPC) delivered a 0.25% increase in Bank Rate at its meeting on 2 November. This removed the emergency cut in August 2016 after the EU referendum. The MPC also gave forward guidance that they expected to increase Bank rate only twice more by 0.25% by 2020 to end at 1.00%. The Link Asset Services forecast as above includes increases in Bank Rate of 0.25% in November 2018, November 2019 and August 2020.

The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. It has long been expected, that at some point, there would be a more protracted move from bonds to equities after a historic long-term trend, over about the last 25 years, of falling bond yields. The action of central banks since the financial crash of 2008, in implementing substantial Quantitative Easing, added further impetus to this downward trend in bond yields and rising bond prices. Quantitative Easing has also directly led to a rise in equity values as investors searched for higher returns and took on riskier assets. The sharp rise in bond yields since the US Presidential election in November 2016 has called into question whether the previous trend may go into reverse, especially now the Fed. has taken the lead in reversing monetary policy by starting, in October 2017, a policy of not fully reinvesting proceeds from bonds that it holds when they mature.

Until 2015, monetary policy was focused on providing stimulus to economic growth but has since started to refocus on countering the threat of rising inflationary pressures as stronger economic growth becomes more firmly established. The Fed. has started raising interest rates and this trend is expected to continue during 2018 and 2019. These increases will make holding US bonds much less attractive and cause their prices to fall, and therefore bond yields to rise. Rising bond yields in the US are likely to exert some upward pressure on bond yields in the UK and other developed economies. However, the degree of that upward pressure is likely to be dampened by how strong or weak the prospects for economic growth and rising inflation are in each country, and on the degree of progress towards the reversal of monetary policy away from quantitative easing and other credit stimulus measures.

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 and emerging market developments. Such volatility could occur at any time during the forecast period.

Economic and interest rate forecasting remains difficult with so many external influences weighing on the UK. The above forecasts (and MPC decisions) will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Geopolitical developments, especially in the EU, could also have a major impact. Forecasts for average investment earnings beyond the three-year time horizon will be heavily dependent on economic and political developments.

The overall balance of risks to economic recovery in the UK is probably to the downside, particularly with the current level of uncertainty over the final terms of Brexit.

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

- The Bank of England takes action too quickly 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.
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.
- A resurgence of the Eurozone sovereign debt crisis, possibly Italy, due to its high level of government debt, low rate of economic growth and vulnerable banking system.
- Weak capitalisation of some European banks.
- Germany is still without an effective government after the inconclusive result of the general election in October. In addition, Italy is to hold a general election on 4 March and the anti EU populist Five Star party is currently in the lead in the polls, although it is unlikely to get a working majority on its own. Both situations could pose major challenges to the overall leadership and direction of the EU as a whole and of the individual respective countries. Hungary will hold a general election in April 2018.
- The result of the October 2017 Austrian general election has now resulted in a strongly anti-immigrant coalition government. In addition, the Czech ANO party became the largest party in the October 2017 general election on a platform of being strongly against EU migrant quotas and refugee policies. Both developments could provide major impetus to other, particularly former Communist bloc countries, to coalesce to create a major block to progress on EU integration and centralisation of EU policy. This, in turn, could spill over into impacting the Euro, EU financial policy and financial markets.
- Rising protectionism under President Trump
- A sharp Chinese downturn and its impact on emerging market countries

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

- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
-

- UK inflation returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.
- The Fed causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal of Quantitative Easing, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.

Investment and borrowing rates

- Investment returns are likely to remain low during 2018/19 but to be on a gently rising trend over the next few years.
- Borrowing interest rates increased sharply after the result of the general election in June and then also after the September MPC meeting when financial markets reacted by accelerating their expectations for the timing of Bank Rate increases. Apart from that, there has been little general trend in rates during the current financial year. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in the future when authorities may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt;
- There will remain a cost of carry to any new long-term borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost – the difference between borrowing costs and investment returns.

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

3.4 Borrowing strategy

The Council is currently maintaining an under-borrowed (internally-borrowed) position (£21.5 million at the end of financial year 2016/17). 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 2018/19 treasury operations. The Head of Finance & Integrated Service Support 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 start date and in the rate of increase in central rates in the USA and UK, an unexpected 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.

The current low Bank of England base rate level of 0.50% and the expectation that any base rate rises will follow a shallow upward trajectory in the short-medium term, means that continued utilisation of temporary borrowing within the Council's overall loan portfolio (current level of £18.0 million as at 26 January 2018 at an average borrowing rate of 0.31% as shown in Table 1) 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 loans at historically low medium-long term rates, particularly given the projected gradual rise in PWLB rates.

Long-term borrowing rates from the Debt Management Office's (DMO) Public Works Loans Board (PWLB) are currently sitting at, or close to, historical lows. Whilst the Council has already secured long-term borrowing for financial year 2017/18, as can be noted from Table 3 above the Council has a significant borrowing requirement across the forthcoming 3 financial years (2018/19 to 2020/21).

Part of this borrowing requirement has already been secured through the second of the Council's two forward dealt loans. This involved the Council committing to draw down two £10 million loans at fixed interest rates that were priced against historically low borrowing rates, with minimal cost of carry and allowed the Council to hedge against future borrowing rate movements, thereby representing an extremely viable alternative to traditional PWLB borrowing and adding certainty to the Council's loan portfolio. The first of these two loans was drawn on 29 June 2017 and the second will be drawn on 15 November 2018, with both of these dates matched to two £10 million PWLB loans maturing on the same dates.

It is expected that the majority of the remaining borrowing requirement to fund capital expenditure incurred in 2018/19 and 2019/20 shall be sourced from a blend of internal borrowing, further temporary borrowing and by locking in to longer term PWLB borrowing to manage longer term risk for the loan portfolio. However, the opportunity 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 2017/18 and into 2018/19.

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 of £482.021 million proposed below.

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:

| Table 13: Treasury Indicators & Limits | | | |
|---|----------------|----------------|----------------|
| | 2017/18 | 2018/19 | 2019/20 |
| Interest rate exposures | Upper | Upper | Upper |
| Limits on fixed interest rates based on gross debt | 100.00% | 100.00% | 100.00% |
| Limits on variable interest rates based on gross debt | 30.00% | 30.00% | 30.00% |
| Limits on fixed interest rates based on investments | 100.00% | 100.00% | 100.00% |
| Limits on variable interest rates based on investments | 100.00% | 100.00% | 100.00% |
| Maturity structure of fixed interest rate borrowing 2018/19 | | 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 2018/19 | | 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 has regard to the Scottish Government's Investment (Scotland) Regulations (and accompanying Finance Circular) and the CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2017 ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second and then return.

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. The key ratings used to monitor counterparties are the Short Term and Long Term ratings.

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.

Investment instruments identified for use in the financial year are listed in appendices 5.2 and 5.3. Counterparty limits will be as set through the Council's treasury management practices – schedules.

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 | |
|--|--|
| Sector 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.

4.3 Country and sector limits

The Council has determined that it will only use approved counterparties 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 5.5. 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 each of the two UK-government backed banks (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

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 (i.e. rates for investments up to 12 months).

Investment returns expectations. Bank Rate is forecast to stay flat at 0.25% until quarter 2 2019 and not to rise above 0.75% by quarter 1 of 2020. Bank Rate forecasts for financial year ends (March) are

- 2017/18 0.50%
- 2018/19 0.75%
- 2019/20 1.00%
- 2020/21 1.25%

The overall balance of risks to these forecasts is currently to the downside (i.e. start of increases in Bank Rate occurs later). However, should the pace of growth quicken and / or forecasts for increases in inflation rise, there could be an upside risk.

The suggested budgeted investment earnings rates for returns on investments placed for periods of up to 100 days during each financial year for the next 3 years are as follows:-

- 2017/18 0.40%
- 2018/19 0.60%
- 2019/20 0.90%
- 2020/21 1.25%
- 2021/22 1.50%

The overall balance of risks to these forecasts is currently skewed to the upside and are dependent on how strong GDP growth turns out, how quickly inflation pressures rise and how quickly the Brexit negotiations move forward positively.

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 to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

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

| Table 15: Principal Sums Invested for > 365 Days | | | |
|--|----------------|----------------|----------------|
| | 2017/18 | 2018/19 | 2019/20 |
| Limit | £50m | £50m | £50m |

The current strategy as outlined in the body of these reports is to cash-back the Council's balance sheet reserves. It is expected that the majority of this will be in the form of 12 month fixed term deposits and/or certificates of deposit. The limit for principal sums invested for > 365 days has been set at £50m to give the Council flexibility to extend the duration of such deposits on the margins, to e.g. 366 days or 13/14 months. As noted in Section 4.3, 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.

For its cash flow generated balances, the Council will seek to utilise its business reserve instant access and notice accounts, money market funds and short-dated deposits (overnight to 100 days) in order to benefit from the compounding of interest.

4.5 Investment risk benchmarking

The Council will use an investment benchmark to assess the investment performance of its investment portfolio of 6 month LIBID compounded.

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

GLOBAL OUTLOOK: World growth looks to be on an encouraging trend of stronger performance, rising earnings and falling levels of unemployment. In October, the IMF upgraded its forecast for world growth from 3.2% to 3.6% for 2017 and 3.7% for 2018.

In addition, inflation prospects are generally muted and it is particularly notable that wage inflation has been subdued despite unemployment falling to historically very low levels in the UK and US. This has led to many comments by economists that there appears to have been a fundamental shift downwards in the Phillips curve (this plots the correlation between levels of unemployment and inflation e.g. if the former is low the latter tends to be high). In turn, this raises the question of what has caused this? The likely answers probably lay in a combination of a shift towards flexible working, self-employment, falling union membership and a consequent reduction in union power and influence in the economy, and increasing globalisation and specialisation of individual countries, which has meant that labour in one country is in competition with labour in other countries which may be offering lower wage rates, increased productivity or a combination of the two. In addition, technology is probably also exerting downward pressure on wage rates and this is likely to grow with an accelerating movement towards automation, robots and artificial intelligence, leading to many repetitive tasks being taken over by machines or computers. Indeed, this is now being labelled as being the start of the fourth industrial revolution.

KEY RISKS: central bank monetary policy measures

Looking back on nearly ten years since the financial crash of 2008 when liquidity suddenly dried up in financial markets, it can be assessed that central banks' monetary policy measures to counter the sharp world recession were successful. The key monetary policy measures they used were a combination of lowering central interest rates and flooding financial markets with liquidity, particularly through unconventional means such as Quantitative Easing (QE), where central banks bought large amounts of central government debt and smaller sums of other debt.

The key issue now is that that period of stimulating economic recovery and warding off the threat of deflation is coming towards its close and a new period has already started in the US, and more recently in the UK, on reversing those measures i.e. by raising central rates and (for the US) reducing central banks' holdings of government and other debt. These measures are now required in order to stop the trend of an on-going reduction in spare capacity in the economy, and of unemployment falling to such low levels that the re-emergence of inflation is viewed as a major risk. It is, therefore, crucial that central banks get their timing right and do not cause shocks to market expectations that could destabilise financial markets. In particular, a key risk is that because QE-driven purchases of bonds drove up the price of government debt, and therefore caused a sharp drop in income yields, this then also encouraged investors into a search for yield and into investing in riskier assets such as equities. This resulted in bond markets and equity market prices both rising to historically high valuation levels simultaneously. This, therefore, makes both asset categories vulnerable to a sharp correction. It is important, therefore, that central banks only gradually unwind their holdings of bonds in order to prevent destabilising the financial markets. It is also likely that the timeframe for central banks unwinding their holdings of QE debt purchases will be over several years. They need to balance their timing to neither squash economic recovery by taking too rapid and too strong action, or, alternatively, let inflation run away by taking action that was too slow and/or too weak. The potential for central banks to get this timing and strength of action wrong are now key risks.

There is also a potential key question over whether economic growth has become too dependent on strong central bank stimulus and whether it will maintain its momentum against a backdrop of rising interest rates and the reversal of QE. In the UK, a key vulnerability is the low level of productivity growth, which may be the main driver for increases in wages; and decreasing consumer disposable income, which is important in the context of consumer expenditure primarily underpinning UK GDP growth.

A further question that has come to the fore is whether an inflation target for central banks of 2%, is now realistic given the shift down in inflation pressures from internally generated inflation, (i.e. wage inflation feeding through into the national economy), given the above mentioned shift down in the Phillips curve.

- Some economists favour a shift to a lower inflation target of 1% to emphasise the need to keep the lid on inflation. Alternatively, it is possible that a central bank could simply 'look through' tepid wage inflation, (i.e. ignore the overall 2% inflation target), in order to take action in raising rates sooner than might otherwise be expected.
- However, other economists would argue for a shift UP in the inflation target to 3% in order to ensure that central banks place the emphasis on maintaining economic growth through adopting a slower pace of withdrawal of stimulus.
- In addition, there is a strong argument that central banks should target financial market stability. As mentioned previously, bond markets and equity markets could be vulnerable to a sharp correction. There has been much commentary, that since 2008, QE has caused massive distortions, imbalances and bubbles in asset prices, both financial and non-financial. Consequently, there are widespread concerns at the potential for such bubbles to be burst by exuberant central bank action. On the other hand, too slow or weak action would allow these imbalances and distortions to continue or to even inflate them further.
- Consumer debt levels are also at historically high levels due to the prolonged period of low cost of borrowing since the financial crash. In turn, this cheap borrowing has meant that other non-financial asset prices, particularly house prices, have been driven up to very high levels, especially compared to income levels. Any sharp downturn in the availability of credit, or increase in the cost of credit, could potentially destabilise the housing market and generate a sharp downturn in house prices. This could then have a destabilising effect on consumer confidence, consumer expenditure and GDP growth. However, no central bank would accept that it ought to have responsibility for specifically targeting house prices.

UK: After the UK surprised on the upside with strong economic growth in 2016, growth in 2017 has been disappointingly weak; quarter 1 came in at only +0.3% (+1.8% y/y), quarter 2 was +0.3% (+1.5% y/y) and quarter 3 was +0.4% (+1.5% y/y). The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling after the EU referendum, feeding increases in the cost of imports into the economy. This has caused, in turn, a reduction in consumer disposable income and spending power and so the services sector of the economy, accounting for around 80% of GDP, has seen weak growth as consumers cut back on their expenditure. However, more recently there have been encouraging statistics from the manufacturing sector which is seeing strong growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year while robust world growth has also been supportive. However, this sector only accounts for around 10% of GDP so expansion in this sector will have a much more muted effect on the overall GDP growth figure for the UK economy as a whole.

While the Bank of England is expected to give forward guidance to prepare financial markets for gradual changes in policy, the Monetary Policy Committee, (MPC), meeting of 14 September 2017 managed to shock financial markets and forecasters by suddenly switching to a much more aggressive tone in terms of its words around warning that Bank Rate will need to rise soon. The Bank of England Inflation Reports during 2017 have clearly flagged up that it expected CPI inflation to peak at just under 3% in 2017, before falling back to near to its target rate of 2% in two years' time. The Bank revised its forecast for the peak to just over 3% at the 14 September meeting. (Inflation actually came in at

3.1% in November so that may prove now to be the peak. Inflation fell to 3.0% in December.) This marginal revision in the Bank's forecast can hardly justify why the MPC became so aggressive with its wording; rather, the focus was on an emerging view that with unemployment having already fallen to only 4.3%, the lowest level since 1975, and improvements in productivity being so weak, that the amount of spare capacity in the economy was significantly diminishing towards a point at which they now needed to take action. In addition, the MPC took a more tolerant view of low wage inflation as this now looks like a common factor in nearly all western economies as a result of automation and globalisation. However, the Bank was also concerned that the withdrawal of the UK from the EU would effectively lead to a decrease in such globalisation pressures in the UK, and so this would cause additional inflationary pressure over the next few years.

At Its 2 November meeting, the MPC duly delivered a 0.25% increase in Bank Rate. It also gave forward guidance that they expected to increase Bank Rate only twice more in the next three years to reach 1.0% by 2020. This is, therefore, not quite the 'one and done' scenario but is, nevertheless, a very relaxed rate of increase prediction in Bank Rate in line with previous statements that Bank Rate would only go up very gradually and to a limited extent.

However, some forecasters are flagging up that they expect growth to accelerate significantly towards the end of 2017 and then into 2018. This view is based primarily on the coming fall in inflation, (as the effect of the effective devaluation of sterling after the EU referendum drops out of the CPI statistics), which will bring to an end the negative impact on consumer spending power. In addition, a strong export performance will compensate for weak services sector growth. If this scenario was indeed to materialise, then the MPC would be likely to accelerate its pace of increases in Bank Rate during 2018 and onwards.

It is also worth noting the contradiction within the Bank of England between action in 2016 and in 2017 by two of its committees. After the shock result of the EU referendum, the Monetary Policy Committee (MPC) voted in August 2016 for emergency action to cut Bank Rate from 0.50% to 0.25%, restarting £70bn of QE purchases, and also providing UK banks with £100bn of cheap financing. The aim of this was to lower borrowing costs, stimulate demand for borrowing and thereby increase expenditure and demand in the economy. The MPC felt this was necessary in order to ward off their expectation that there would be a sharp slowdown in economic growth. Instead, the economy grew robustly, although the Governor of the Bank of England strongly maintained that this was because the MPC took that action. However, other commentators regard this emergency action by the MPC as being proven by events to be a mistake. Then in 2017, we had the Financial Policy Committee (FPC) of the Bank of England taking action in June and September over its concerns that cheap borrowing rates, and easy availability of consumer credit, had resulted in too rapid a rate of growth in consumer borrowing and in the size of total borrowing, especially of unsecured borrowing. It, therefore, took punitive action to clamp down on the ability of the main banks to extend such credit! Indeed, a PWC report in October 2017 warned that credit card, car and personal loans and student debt will hit the equivalent of an average of £12,500 per household by 2020. However, averages belie wide variations in levels of debt with much higher exposure being biased towards younger people, especially the 25 -34 year old band, reflecting their lower levels of real income and asset ownership.

One key area of risk is that consumers may have become used to cheap rates since 2008 for borrowing, especially for mortgages. It is a major concern that some consumers may have over extended their borrowing and have become complacent about interest rates going up after Bank Rate had been unchanged at 0.50% since March 2009 until falling further to 0.25% in August 2016. This is why forward guidance from the Bank of England continues to emphasise slow and gradual increases in Bank Rate in the coming years. However, consumer borrowing is a particularly vulnerable area in terms of the Monetary Policy Committee getting the pace and strength of Bank Rate increases right - without causing a sudden shock to consumer demand, confidence and thereby to the pace of economic growth.

Moreover, while there is so much uncertainty around the Brexit negotiations, consumer confidence, and business confidence to spend on investing, it is far too early to be confident about how the next two to three years will actually pan out.

EZ: Economic growth in the eurozone (EZ), (the UK's biggest trading partner), had been lack lustre for several years after the financial crisis despite the ECB eventually cutting its main rate to -0.4% and embarking on a massive programme of QE. However, growth picked up in 2016 and has now gathered substantial strength and momentum thanks to this stimulus. GDP growth was 0.6% in quarter 1 (2.1% y/y), 0.7% in quarter 2 (2.4% y/y) and +0.6% in quarter 3 (2.6% y/y). However, despite providing massive monetary stimulus, the European Central Bank is still struggling to get inflation up to its 2% target and in December inflation was 1.4%. It is therefore unlikely to start on an upswing in rates until possibly 2019. It has, however, announced that it will slow down its monthly QE purchases of debt from €60bn to €30bn from January 2018 and continue to at least September 2018.

USA: Growth in the American economy was notably erratic and volatile in 2015 and 2016. 2017 is following that path again with quarter 1 coming in at only 1.2% but quarter 2 rebounding to 3.1% and quarter 3 coming in at 3.3%. Unemployment in the US has also fallen to the lowest level for many years, reaching 4.1%, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has started on a gradual upswing in rates with four increases in all and four increases since December 2016; the latest rise was in December 2017 and lifted the central rate to 1.25 – 1.50%. There could then be another four increases in 2018. At its September meeting, the Fed said it would start in October to gradually unwind its \$4.5 trillion balance sheet holdings of bonds and mortgage backed securities by reducing its reinvestment of maturing holdings.

CHINA: Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

JAPAN: GDP growth has been gradually improving during 2017 to reach an annual figure of 2.1% in quarter 3. However, it is still struggling to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

Brexit timetable and process

- March 2017: UK government notifies the European Council of its intention to leave under the Treaty on European Union Article 50
- March 2019: initial two-year negotiation period on the terms of exit. In her Florence speech in September 2017, the Prime Minister proposed a two year transitional period after March 2019.
- UK continues as a full EU member until March 2019 with access to the single market and tariff free trade between the EU and UK. Different sectors of the UK economy will leave the single market and tariff free trade at different times during the two year transitional period.
- The UK and EU would attempt to negotiate, among other agreements, a bi-lateral trade agreement over that period.
- The UK would aim for a negotiated agreed withdrawal from the EU, although the UK could also exit without any such agreements in the event of a breakdown of negotiations.
- If the UK exits without an agreed deal with the EU, World Trade Organisation rules and tariffs could apply to trade between the UK and EU - but this is not certain.
- On full exit from the EU: the UK parliament would repeal the 1972 European Communities Act.

- The UK will then no longer participate in matters reserved for EU members, such as changes to the EU's budget, voting allocations and policies.

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.** As they are quasi-Government bodies with low counterparty and value risk, they typically offer low rates of return. 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..

- b. **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.
- c. **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.
- d. **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.
- e. **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.
- f. **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 will involve the Council subscribing £333,000 of subordinated debt to the SPV that has been set up to deliver the Newbattle Centre project (2 year construction and 25 year operational contract length). The length of the investment will be 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 a thorough 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.

Table 1: Permitted Investments

This table is for use by the in house treasury management team.

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% | 2 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% | 1 day |
| 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 | 10%) | 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+1 | Yes | 100% | Up to 6 yrs Up to 3 yrs Up to 2 yrs Up to 2 yrs Up to 7 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 7 mths Up to 100 days Not for use |
| Floating rate notes | 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 7 mths Up to 100 days Not for use |
| Corporate Bonds other | Yellow Purple Blue Orange Red Green No Colour | Sale T+3 | Yes | 100% | Up to 6 yrs Up to 3 yrs Up to 2 yrs Up to 2 yrs Up to 7 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 | 20 years |
| Subordinated Debt Subscription to Newbattle Centre SPV | n/a | Term | No | £0.400m | 25 years |
| Property Funds | n/a | T+4 | Yes | 50% | 15 years |

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. Liquidity may present a problem as 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. | <p>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.</p> <p>On day to day investment dealing with this criteria will be further strengthened by the use of additional market intelligence.</p> | 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. | <p>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.</p> <p>On day to day investment dealing, this criteria will be further strengthened by the use of additional market intelligence.</p> | 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. |

| | | | |
|---|---|---|---------------------------|
| 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. |
| 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. |

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 Head of Finance & Integrated Service Support, 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 15.02.16)

AAA

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

AA+

- Finland
- Hong Kong
- U.S.A.

AA

- Abu Dhabi (UAE)
- France
- U.K.

AA-

- Belgium
- Qatar

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 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.