

Notice of Meeting and Agenda



Audit Committee

Venue: Virtual Meeting,

Date: Tuesday, 25 January 2022

Time: 11:00

Executive Director : Place

Contact:

Clerk Name: Democratic Services
Clerk Telephone:
Clerk Email: democratic.services@midlothian.gov.uk

Further Information:

This is a meeting which is open to members of the public.

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1 Welcome, Introductions and Apologies

2 Order of Business

Including notice of new business submitted as urgent for consideration at the end of the meeting.

3 Declaration of Interest

Members should declare any financial and non-financial interests they have in the items of business for consideration, identifying the relevant agenda item and the nature of their interest.

4 Minute of Previous Meeting

4.1 Minute of the Meeting of 7 December 2021 submitted for approval 3 - 10

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5 Public Reports

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5.4 External Audit Annual Report to Members and the Controller of Audit for the year ended 31 March 2021 – Update on recommendations 119 - 126

5.5 Shared Internal Audit Services and Proposed Way Forward 2022-23 - Chief Executive 127 - 134

5.6 Accounts Commission report Community Empowerment - Chief Internal Auditor 135 - 136

6 Private Reports

No items for discussion

7 Date of Next Meeting

To be Confirmed

Minute of Meeting

Audit Committee
Tuesday 25 January 2022
Item No: 4.1



Audit Committee

Date	Time	Venue
Tuesday 7 December 2021	11.00am	MS Team – Virtual Meeting

Present:

Mike Ramsay (Independent Chair)
Councillor Cassidy
Councillor Hackett (Substitute)
Councillor Muirhead
Councillor Parry
Councillor Smaill
Councillor Hardie
Mr de Vink (Independent Member)

In attendance:

Grace Vickers	Chief Executive
Alan Turpie	Legal Services Manager/Monitoring Officer
Kevin Anderson	Executive Director Place
Fiona Robertson	Executive Director Children ,Young People and Partnerships
Morag Barrow	Joint Director Health and Social Care
Gary Fairley	Chief Officer Corporate Solutions
Derek Oliver	Chief Officer Place
David Gladwin	Financial Services Manager
Gary Thomson	Senior Accountant
Jill Stacey	Chief Internal Auditor
Myra Forsyth	Quality and Scrutiny Manager
Stephen Reid	External Auditor, E.Y.
Edel Ryan	Senior Manager, Protective Services
Janet R Ritchie	Democratic Services Officer

1. Welcome and Apologies

The Chair, Mike Ramsay, welcomed everyone to the meeting. Apologies were received from Councillor Milligan and it was noted that Councillor Hackett was substituting for Councillor Milligan.

2. Order of Business

The Order of Business was as outlined in the Agenda.

The Chair made reference to the new code of conduct for Councillors agreed by the Scottish Government which came into force today, Tuesday 7 December 2021 and previously circulated to Members by the Monitoring Officer. He highlighted that the previous code of conduct did not specifically reference comments regarding performance of employees and as this Committee frequently considers reports and findings that refer to the performance and operational management of the Council services this needs to be considered in particular the following clauses while conducting today's business:

3.7 I will not become involved in operational management of my council's services as I acknowledge and understand that is the responsibility of its employees.

3.8 I will not undermine any individual employee or group of employees, or raise concerns about their performance, conduct or capability in public.

3. Declarations of interest

No declarations of interest were received.

4. Minutes of Previous Meetings

- 4.1 The minute of the meeting of 28 September 2021 was submitted and approved as a correct record having been proposed by Councillor Muirhead seconded by Councillor Smail.
- 4.2 The Action log was submitted and the following noted:
 - 1) Internal Audit Annual Assurance Report 2019/20 – Risk Management Policy and Strategy - March 2022 – on Agenda Item 5.7
 - 2) Financial Reports, Council Meetings: Reports with a financial element relevant to Audit are made available to the Independent Members of the Audit Committee – It was agreed that this item is now complete as a process is place for this action with Chief Officer, Corporate Solutions and Democratic Services – Completed.
 - 3) Internal Audit Recommendations – Agenda 28 September 2021 – Completed.

- 4) Report on reconciliation of Social Housing work in progress and completions – on Agenda 28 September 2021 - Completed
- 5) Property Maintenance – BTSG report - Mr Anderson advised the committee on the reasons why this report was delayed and it was noted that the report would be presented to the BTSG meeting on 24 January 2022 and that if appropriate would be referred on to the Audit Committee thereafter – Revised expected completion date March 2022.
- 6) Annual Audit Report to Members and the Controller of Audit – year ended 31 March 2021 - The implementation dates of EY recommendations range from March 2022 to September 2022, though a progress report will be prepared – January 2022.
- 7) Audit Scotland Fraud and Irregularity Update 2020-21 - A further meeting of the Integrity Group of officers is required to complete the counter fraud controls assessment for improvement and assurance purposes – January 2022.

5. Public Reports

Report No.	Report Title	Presented by:
5.1	Treasury Management Mid-Year Review Report 2021/22	Chief Officer Corporate Solutions
Outline of report and summary of discussion		
<p>The purpose of this report was to inform members of the Audit Committee, and subsequently Council, of the Treasury Management activity undertaken during the first half of 2021/22 and the forecast activity for the second half of 2021/22 in accordance with the Treasury Management and Annual Investment Strategy approved in February 2021. It also provided an update to the Treasury and Prudential Indicators for 2021/22.</p> <p>The Audit Committee was invited to comment on this report before it was presented to Council. In particular, Audit Committee should note the following recommendations which are proposed to be put to Council on 14 December 2021:-</p> <ol style="list-style-type: none"> a) Note the report and the treasury activity undertaken in the period to 30 September 2021, as outlined in Section 5; b) Note the forecast activity during the second-half of the year as outlined in Section 6; c) Approve the technical revisions to the Prudential Indicators in Section 7 of this report. <p>Mr Fairley provided an overview of the main sections contained within the report and advised that the Audit Committee consider the report prior to being presented to Council. He thereafter responded to questions and comments raised by Members of the Committee.</p>		

Decision
The Audit Committee noted the recommendations as detailed which will be presented to Council on 14 December 2021.
Action
Chief Officer Corporate Solutions

Report No.	Report Title	Presented by:
5.2	CIPFA Financial Management Code	Chief Officer Corporate Solutions
Outline of report and summary of discussion		
<p>The Purpose of this report was to introduce the CIPFA Financial Management Code and the findings of the self-assessment that had been undertaken.</p> <p>The Financial Management Code (FM Code) produced by the Chartered Institute of Public Finance and Accountancy (CIPFA) was designed to support good practice in financial management and to assist local authorities in demonstrating their financial sustainability. For the first time, the FM Code sets out the standards of financial management for local authorities. The FM Code is based on a series of principles supported by specific standards which are considered necessary to provide the strong foundation to:</p> <ul style="list-style-type: none"> • Financially manage the short, medium and long-term finances of a local authority. • Manage financial resilience to meet unforeseen demands on services. • Manage unexpected shocks in their financial circumstances. <p>Mr Fairley presented this report outlining the main details contained within the report and highlighted the key principles and actions. Thereafter Mr Fairley responded to questions and comments raised by the Committee providing clarity on the Self-assessment process.</p>		
Decision		
<p>The Audit Committee noted:</p> <ul style="list-style-type: none"> • The assessment and improvement actions arising from the self-assessment against the CIPFA FM Code; • An annual progress report will be presented to CMT. 		
Action		
Chief Officer Corporate Solutions		

Report No.	Report Title	Presented by:
5.3	Internal Audit Work to October 2021	Chief Internal Auditor
Outline of report and summary of discussion		
<p>The purpose of this report was to provide members of the Audit Committee with details of the recent work carried out by Internal Audit and the findings and recommended audit actions agreed by Management to improve internal controls and governance arrangements.</p>		

The Internal Audit Annual Plan 2021/22 was approved by the Audit Committee on 9 March 2021. Internal Audit has carried out work associated with the delivery of the Plan to meet its objective of providing an opinion on the efficacy of the Council's risk management, internal control and governance.

An Executive Summary of the final Internal Audit assurance reports issued, including audit objective, findings, good practice and recommendations (where appropriate), and the Chief Internal Auditor's independent and objective opinion on the adequacy of the control environment and governance arrangements within each audit area, is shown in Appendix 1.

The Chief Internal Auditor, Jill Stacey, presented this report highlighting the main sections contained within the report and outlined the key messages of assurance and areas of improvement. This included findings and recommendations from Q1 2021/22 Internal Audit review of Risk Management, with reference to other related items on the agenda.

Thereafter Chief Officer Place and Chief Internal Officer responded to questions and comments raised regarding Roads Maintenance advising on the benefits of implementing an improved asset management system.

Decision

The Audit Committee:

- a) Considered the Executive Summaries of the final Internal Audit assurance reports issued;
- b) Noted the Internal Audit Assurance Work in Progress and Internal Audit and Other Work carried out; and
- c) Acknowledged the assurance provided on internal controls and governance arrangements in place for the areas covered by this Internal Audit work.

Report No.	Report Title	Presented by:
5.4	Internal Audit Mid-Term Performance Report 2021/22	Chief Internal Auditor
Outline of report and summary of discussion		
<p>The purpose of this report was to inform the Audit Committee of the progress Internal Audit has made, in the first 6 months of the year to 30 September 2021, towards completing the Internal Audit Annual Plan 2021/22. It also summarises the statutory obligations for Internal Audit and requirements of the Public Sector Internal Audit Standards.</p> <p>Internal Audit provides assurance to Management and the Audit Committee on the effectiveness of internal controls and governance within the Council.</p> <p>The Internal Audit Annual Plan 2021/22 that was approved by the Audit Committee on 9 March 2021 sets out the audit coverage for the year utilising available Internal Audit staff resources to enable the Chief Internal Auditor, as the Council's Chief</p>		

Audit Executive (CAE), to provide the statutory annual internal audit opinion regarding the adequacy and effectiveness of internal control within the Council.

The report provides details of the half yearly progress by Internal Audit with its programme of work and highlights changes that require approval to reflect the changing risks arising from Covid-19.

The Chief Internal Auditor presented this report outlining that Internal Audit has made reasonable progress in the first half of the year towards completing the approved Internal Audit Annual Plan 2021/22, despite lower than planned Internal Audit capacity.

Decision

The Audit Committee:

- a) Noted the progress Internal Audit has made with activity in the Internal Audit Annual Plan 2021/22 by the mid-year point;
- b) Confirmed that it is satisfied with the performance of the Internal Audit service provision.

Report No.	Report Title	Presented by:
5.5	Internal Audit Follow-up of Recommendations Progress	Chief Internal Auditor
Outline of report and summary of discussion		
<p>The purpose of this report was to provide an update to members of the Audit Committee on the status of the implementation by Management of audit recommendations made and agreed in Internal Audit reports.</p> <p>Internal Audit is an independent appraisal function established for the review of the internal control system as a service to Midlothian Council. It objectively examines, evaluates and reports on the adequacy of internal control as a contribution to the proper, economic, efficient and effective use of resources and the management of risk.</p> <p>The Internal Audit activity adds value to the organisation (and its stakeholders) when it considers strategies, objectives, and risks; strives to offer ways to enhance governance, risk management and control processes (by way of making audit recommendations); and objectively provides relevant assurance. The Remit of the Audit Committee includes "To consider reports on the effectiveness of internal controls and monitor the implementation of agreed actions", as part of its high level oversight of the Council's governance, risk management and control framework.</p> <p>The Chief Internal Auditor presented this report highlighting the main sections contained within the report and progress made by Management in implementing the audit recommendations as detailed within the report.</p>		
Decision		
<p>The Audit Committee:</p> <ul style="list-style-type: none">a) Acknowledge the progress made by Management in implementing Internal Audit recommendations to improve internal controls and governance, to		

mitigate risks, and consider whether it is satisfied with the progress made by Management; and
b) Noted that Internal Audit will continue to monitor for completion the outstanding recommendations and will provide update reports to the Audit Committee.
Action
Chief Internal Auditor

Report No.	Report Title	Presented by:
5.6	Risk Management Update, Quarter 2 2021/22	Chief Officer Place
Outline of report and summary of discussion		
<p>The purpose of this report was to provide Audit Committee with an update on the risk responses Midlothian Council has implemented during Quarter 2 2021/22 to respond to the current risk climate; and to provide assurance that Midlothian Council took a proportionate and planned approach to prepare and respond to each of the identified risks.</p> <p>The Chief Officer Place, Derek Oliver, presented this report to the Audit Committee highlighting for the Council the critical Strategic issue is COVID and the highest Strategic Risks were Early Years Expansion and the Scottish Child Abuse Inquiry and also provided details on the Strategic Opportunities to the Council as set out in the report.</p> <p>Thereafter Mr Oliver responded to questions and comments raised by members of the committee relating to the UK exit from EU confirming there was no significant impacts regarding operations but remain mindful of any EU exit implications on the local economy.</p> <p>Also raised was the two Capital projects, Midlothian Energy and Destination Hillend, and having a direct focus on these two major projects. Mr Oliver and Mr Anderson in responding advised that with regards to the Risk Management strategy these would be given consideration and both these projects would be included in the future quarterly reporting, it was also highlighted that Destination Hillend due to the size of this project had its own Risk Register.</p> <p>There followed a discussion regarding UK exit from EU and the reporting of any impacts relevant to the Local Authority.</p>		
Decision		
The Audit Committee noted the current risk landscape and organisational response to the most significant risks in Quarter 2 2021/22.		
Action		
Chief Officer Place		

Report No.	Report Title	Presented by:
5.7	Draft Risk Management Policy and Strategy	Chief Officer Place
Outline of report and summary of discussion		
<p>Mr Oliver advised that the draft Risk Management Policy and Strategy was presented to provide assurance to Members that a review of Risk Management is underway. The Strategy reflects the approach and process that the Council undertakes and identifies in managing risk together with its revised objectives.</p> <p>Mr Oliver provided an update on the new Risk Management and Resilience Group which has a strategic oversight on all strategic risks and he provided further details on some of the main items contained within the report.</p> <p>He further advised that the purpose of highlighting this version at this stage was to test these proposals in the coming weeks and also to request feedback from this committee for consideration in the next version with a view to finalising this Strategy in the New Year.</p> <p>The Chair highlighted that on reviewing this he had expected the management of risks would be risk score related and that risks that nothing could be done about should perhaps only be reported on yearly whereas medium risks perhaps quarterly and high/critical risks monthly. There followed a brief discussion relating to this and Mr Oliver advised that this would be given consideration and it was agreed that perhaps only the risks where there has been a change in or any emerging risks should be reported on a monthly basis although it was confirmed that the risks would continue to be monitored by Officers. It was also confirmed by the Chief Internal Auditor that Internal Audit would also be involved in the Risk Management and Resilience Group as a critical friend and would continue to work with Derek and his Managers with regards to the review and update of the Risk Management Policy and Strategy. The Chair also highlighted that guidance for those assessing risks should be included so they had a framework to assess where the impact comes.</p>		
Decision		
The Audit Committee noted the report and provided feedback for consideration.		
Action		
Chief Officer Place		

6. Private Reports

No private reports were submitted.

7. Date of Next Meeting

The next meeting will be held on Tuesday 25 January 2022 at 11 am

The meeting terminated at 12.58 pm

Action Log

Audit Committee
Tuesday 25 January 2022
Item No: 4.2



No	Subject	Date	Action	Action Owner	Expected completion date	Comments
1	Internal Audit Annual Assurance Report 2019/20 – Risk Management Policy and Strategy	22/06/2020	Agreed that a report would be requested on the review and scrutiny of the Risk Management Policy and Strategy	Chief Officer Place	March 2022	Findings from Q1 2021/22 Internal Audit review of Risk Management were presented on 7 December 2021. Risk Management Policy and Strategy review and revisions underway.
2	Property Maintenance	04/05/2021	BTSG report to be circulated to members of the Audit Committee when completed.	Executive Director Place	March 2022	The report will be presented to the Business Transformation Steering Group in January 2022 and if appropriate thereafter referred to the next Audit Committee meeting.
3	Annual Audit Report to Members and the Controller of Audit - year ended 31 March 2021	28/09/2021	A progress report would be brought back to the Committee in January 2022 on the implementation and progress of the EY recommendations.	Chief Officer Corporate Solutions	January 2022	The implementation dates of EY recommendations range from March 2022 to September 2022, though a progress report will be prepared. Included in 25 January 2022 Agenda - Complete

No	Subject	Date	Action	Action Owner	Expected completion date	Comments
4	Audit Scotland Fraud and Irregularity Update 2020-21	28/09/2021	Noted that the Integrity Group of officers has considered the report as part of their counter fraud role and responsibilities, has agreed next steps and will report back on Management Actions required for improvement and assurance purposes to the Audit Committee in December 2021.	Executive Director Place/Chief Internal Auditor	January 2022	A further meeting of the Integrity Group of officers is required to complete the counter fraud controls assessment for improvement and assurance purposes. Included in 25 January 2022 Agenda - Complete
5	Treasury Management Mid-Year Review Report 2021/22	07/12/2021	To be presented to Council on 14 December 2021	Chief Officer Corporate Solutions	December 2021	Completed

Treasury Management and Investment Strategy 2022/23 & Prudential Indicators**Report for Decision****1 Recommendations**

The Audit Committee is invited to comment on this report before it is presented to Council. In particular, Audit Committee should note the following recommendations which are proposed to be put to Council on 15 February 2022:-

- a) Note that there are no changes proposed to the Treasury Management and Investment Strategy (TMIS) for 2022/23 from the strategy currently in place, other than to update the Prudential Indicators (the three key prudential indicators relating to external borrowing as outlined in Section 4, and the remaining indicators as outlined in Appendix 2), to reflect the revised capital plans;
- b) Note the retention of the current approach for the repayment of loans fund advances; and
- c) Accordingly approve the Treasury Management and Investment Strategy for 2022/23.

2 Purpose of Report/Executive Summary

In accordance with the Treasury Management Code of Practice, the annual Treasury Management & Investment Strategy (TMIS) & Prudential Indicators report is required to be adequately scrutinised before being recommended to the Council. For Midlothian, this role is undertaken by the Audit Committee, with this report being presented to Audit Committee on 25 January 2022 prior to consideration by Council on 15 February 2022.

The purpose of the report to Council will be to provide an update on the implementation of the Council's TMIS 2021/22, and to make recommendations to facilitate consideration of the 2022/23 Strategy, specifically the TMIS for 2022/23, the 2021 update to the Prudential and Treasury Management Codes, the Prudential and Treasury indicators contained therein, and the approach to the statutory repayment of loans fund advances.

Any revisions arising from Audit Committee consideration of the report on 25 January 2022 will be incorporated into the final version of the report to Council on 15 February 2022.

Date: 13 January 2022

Report Contact:

Gary Fairley, Chief Officer Corporate Solutions

gary.fairley@midlothian.gov.uk

0131 271 3110

3. Update on implementation of TMIS for 2021/22

3.1 Current Borrowing and Deposit Portfolio

3.1.1 Borrowing

The Council's borrowing position as set out in the 2021/22 Treasury Management Mid-Year Review Report was £274.795 million at 31 March 2021, and six months later was £273.701 million on 30 September 2021.

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

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

Market conditions in early December 2021 supported action to secure further long-term borrowing. The Council, on 9 December 2021, borrowed £50.000 million from PWLB (loan start date 16 December 2021) as shown in table 1 below. This action secured c. 20% of the Council's medium-term borrowing requirement (see Table 3) at historically low PWLB rates, reducing the weighted average interest rate of borrowing and with tenors which manage the refinancing risk in the long term.

Table 1: PWLB Borrowing Undertaken on 16 December 2021

Loan Value (£000's)	Loan Type	Start Date	Maturity Date	Tenor (years)	Interest Rate
10,000	Maturity	16 Dec 2021	16 Dec 2071	50	1.26%
10,000	Maturity	16 Dec 2021	16 Dec 2070	49	1.27%
10,000	Maturity	16 Dec 2021	16 Dec 2067	46	1.30%
10,000	Maturity	16 Dec 2021	16 Dec 2064	43	1.34%
10,000	Maturity	16 Dec 2021	16 Dec 2063	42	1.36%
50,000	Weighted Average			46	1.31%

The initial cost of carry from borrowing on 16 December 2021 was justified; had the Council deferred borrowing the £50.000 million until 2022/23, the overall additional net cash cost to the Council over the life of the loans is predicted to have been £13.284 million, based on the forecast PWLB borrowing rates for 2022/23 of between 1.80% and 1.90%.

Furthermore, as an example of the effectiveness of this strategy, were the Council to have borrowed £50.000 million on 7 January 2022, the equivalent PWLB borrowing rates for the same loan tenors as noted in

Table 1 above were between 1.82% and 1.91%. This would have resulted in a net additional cash cost to the Council over the life of the loans of £12.795 million.

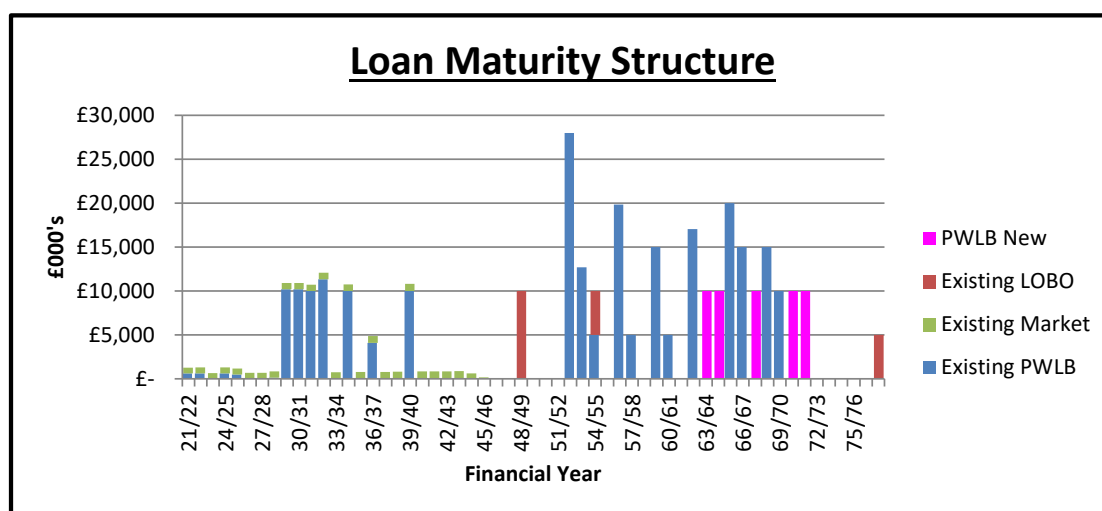
The provisions of the approved TMIS for 2021/22 have allowed Council officers to make time critical operational decisions – in line with the policy – that continue to secure best value in funding capital investment in the Council's asset base.

The Council's loan portfolio, as at 7 January 2022, is shown in table 2 below:-

Table 2: Current Loan Portfolio as at 7 January 2022

Loan Type	Principal Outstanding £000's	Weighted Average Rate
PWLB Annuity	523	8.91%
PWLB Maturity	284,776	2.70%
LOBO	20,000	4.51%
Market Loans	17,721	2.68%
Salix Loans	400	0.00%
Total Loans	323,450	2.81%

The repayment profile of this debt is shown in graphical and tabular form below:-



Financial Year	2021/22 Remaining £000's	2022/23- 2025/26 £000's	2026/27- 2030/31 £000's	2031/32- 2035/36 £000's	2036/37+ £000's
Debt Maturing	180	5,035	23,923	37,203	257,109
% of total portfolio	0.06%	1.56%	7.40%	11.50%	79.49%

As can be noted in the graph and table above, proactive Treasury Management by the Council in the last decade has placed the Council in an extremely strong refinancing position for its existing external debt portfolio, with only £5.215 million, or just 1.61%, of the Council's total Loan Portfolio of £323.450 million requiring refinancing over the current and forthcoming four financial years. This extremely low short-term exposure to refinancing risk has put the Council in a strong

position to plan its new borrowings in advance, take advantage of any dips in longer-term borrowing rates from PWLB (as demonstrated above) and other sources, and maintain a low weighted average coupon rate on external debt.

3.1.2 Deposits

The Council's position for funds on deposit fluctuates on a daily basis, with the 2021/22 Treasury Management Mid-Year Review Report setting out the position at 31 March 2021 of £131.273 million and six months later on 30 September 2021, at £137.590 million.

The position at 7 January 2022, as set out in Table 3 below, totals £165.130 million.

Table 3: Current Deposits as at 7 January 2022

Investment Type	Principal Outstanding £000's	Weighted Average Rate
Bank Call Accounts	17,226	0.05%
Money Market Funds	37,919	0.04%
Bank Notice Accounts	14,985	0.58%
Bank Fixed Term Deposits	35,000	0.41%
Other Local Authorities	60,000	1.62%
Total Investments	165,130	0.74%

The movement is two-fold:

- Following the Council's £50.000 million borrowing from PWLB on 16 December 2021 as outlined in Section 3.1.1 above, fixed term deposits with strong creditworthy bank counterparties totalling £35.000 million have been placed, prior to the expected application of the PWLB loan funds to finance capital expenditure in financial year 2022/23;
- Movement in the bank call accounts and money market funds which are used for day to day liquidity to meet cashflow requirements. The amount held in instant access accounts (£55.145 million as at 7 January 2022) is reflective of (a) the Scottish Government providing upfront funding to local authorities to support a range of grant schemes; (b) advanced Revenue Support Grant payments and Early Years Capital Grant payments in 2021/22; (c) the impact of Covid on the Council's cashflow due to rephasing of capital expenditure plans; (d) the receipt of developer contributions from sites across the County, towards new school, community, road and other infrastructure; and (d) the holding of the remaining £15.000 million PWLB funds prior to the expected application of these funds to capital expenditure in early 2022/23

A full list of deposits placed by the Council at 7 January 2022 is set out in the Treasury Management & Annual Investment Strategy Statement – 2022/23 Detailed in Appendix 4, Section 4.4.

3.2 Borrowing Requirement 2021/22 to 2025/26

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

The projected borrowing requirement arising from the Council's Capital Plans, the MEL Shareholder Injection, and the maturing long-term loans that require to be refinanced, over the period 2021/22 to 2025/26 is shown in table 4:-

Table 4: Total Borrowing Requirement over the period 2021/22 to 2025/26

	2021/22	2022/23	2023/24	2024/25	2025/26	Total
	£000's	£000's	£000's	£000's	£000's	£000's
Capital Expenditure						
General Services	39,828	56,678	58,556	52,823	28,078	235,963
HRA	35,930	82,868	72,346	46,021	12,321	249,486
Total Capital Expenditure	75,758	139,546	130,902	98,844	40,399	485,449
Total Available Financing	-46,502	-45,837	-45,303	-24,043	-12,563	-174,248
Principal Debt Repayments	-9,123	-9,594	-10,781	-11,870	-12,711	-54,079
Capital Expenditure less available Financing	20,133	84,115	74,818	62,931	15,125	257,122
MEL Shareholder Injection	1,190	320	4,810	3,870	0	10,190
Maturing Long-term Loans	1,524	1,465	830	1,531	1,263	6,613
Total Borrowing Requirement	22,847	85,900	80,458	68,332	16,388	273,925
Borrowing secured	-50,000	0	0	0	0	-50,000
Total Remaining Borrowing Requirement	-27,153	85,900	80,458	68,332	16,388	223,925

3.3 Main Objectives of TMIS 2022/23

No material changes are proposed to the current TMIS which was scrutinised by Audit Committee in January 2021 and approved by Council in February 2021. The objectives of the current and proposed TMIS are:-

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

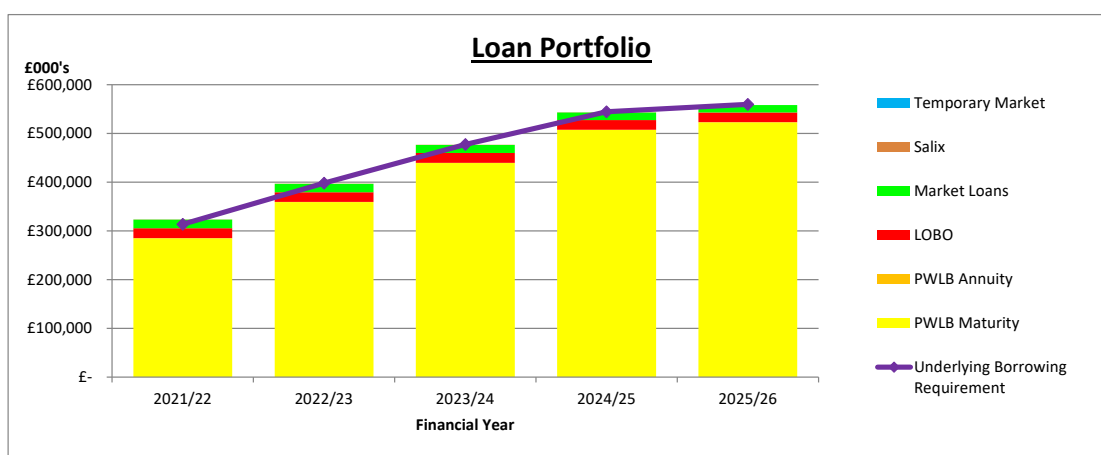
Similarly no changes are recommended to the Permitted Investments, though members should note that reflecting the decision of Council on 14 December 2021 there is a technical adjustment to the maximum level of investment in the Midlothian Energy Limited Joint Venture Energy Services Company (ESCO) to £10.190 million to reflect the decision of 14 December 2021.

More detail on the borrowing and investment strategy for 2022/23 is provided in Sections 3.4 and 3.5 below. Section 4 updates the Prudential Indicators based on the latest Capital Plans, and Section 5 notes no change to the Council's policy for the repayment of loans fund advances from that scrutinised by Audit Committee in January 2021 and approved by Council in February 2021.

3.4 Borrowing Strategy for remainder of 2021/22 and 2022/23

Borrowing is undertaken to finance the Council's approved Capital plans and to do so in the most cost effective way. As can be noted from Table 4 above the Council has a significant borrowing requirement across the current and forthcoming four financial years (2021/22 to 2025/26).

The Council's projected loan portfolio over the period 2021/22 to 2025/26 is shown in graphical format below.



The Council has fully funded its current, and part of its 2022/23, borrowing requirement in a prudent way which balances (a) de-risking the longer term borrowing requirement at historically low longer term borrowing rates; against (b) the current year and forthcoming financial year budget projections.

Long-term PWLB borrowing rates for both HRA and non-HRA purposes have been at historically low levels and significantly below historical averages, with an expected gradual upward trend in these levels across the remainder of financial year 2021/22 and into 2022/23.

The Bank of England's Monetary Policy Committee raised base rate from 0.10% to 0.25% at their meeting on 16 December 2021. There are further rises forecast to base rate in Quarter 4 of 2022 (to 0.50%)

Quarter 1 of 2023 (to 0.75%), Quarter 1 of 2024 (to 1.00%) and finally, Quarter 1 of 2025, which would take the base rate to 1.25%.

With this in mind, utilisation of an element of temporary borrowing – which typically tracks close to base rate levels – within the Council's overall loan portfolio may continue to provide a cost-effective solution to the Council. The quantum of this will continue to be assessed against the backdrop of potential long term costs if the opportunity is missed to take PWLB or other market loans at historically low medium-long term rates, particularly given the projected gradual rise in PWLB rates.

The opportunity also continues to exist to consider further loans on a 'forward dealing' basis, and officers will continue to explore the viability of these loans as part of securing the long term borrowing required to meet the capital financing requirements.

Given the potential for uncertainty in the market to bring a dip in gilt yields and therefore PWLB rates, there may be further opportunities for further long term borrowing to be undertaken in financial year 2021/22 and into early 2022/23 to fund the Council's £224million remaining medium term borrowing requirement to 2025/26 as outlined in Table 4 above. Any further borrowing drawn would be supported by a business case which will appraise the anticipated savings in borrowing costs (from expected increases in rates later in the year / in forthcoming years) against the carrying cost associated with borrowing in advance of need.

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

3.5 Investment Strategy for remainder of 2021/22 and 2022/23

No changes are proposed to the Investment Strategy from that approved by Council in the 2021/22 TMIS.

Council should note that in parallel to securing its external borrowing to finance the capital financing requirement, the strategy means that Council should continue to cash back the Council's useable reserves. In doing so, the Council are able to continue to minimise – or eliminate – the extent of under-borrowing and at the same time de-risk the Council's forward borrowing requirement; whilst also ensuring that all deposits are securely placed with high creditworthy counterparties, complying with the CIPFA Treasury Management Code principles of security, liquidity and then yield – in that order.

This ensures that all deposits are placed with high creditworthy counterparties, with a tenor reflective of the expected drawdown of reserve forecasts, and at a yield commensurate with this. The Council's current deposit portfolio is broadly reflective of the wider UK

Local Authority position, as noted in the table in Section 4.4 of Appendix 4.

The list of Permitted Investments in Appendix 1 also remains unchanged from that approved by Council in the 2021/22 TMIS, other than a technical change to reflect the value of the Council's investment in the Midlothian Energy Limited as referenced earlier.

4 CIPFA Codes & Prudential Indicators

4.1 CIPFA Codes

CIPFA, on 20 December 2021, released the new editions of the Treasury Management Code and Prudential Code.

The main areas that have been updated are summarised in the sections below.

It was proposed to bring forward the full suite of Treasury Management Practices (TMPs) (in full) alongside the TMIS to give AC today the opportunity to scrutinise and endorse these. Given the December release of the new Codes, and the significant work required to update local TMPs, the full suite of revised TMPs will be presented to AC at the earliest opportunity.

Treasury Management Code

1. **TMP1 Credit and Counterparty Risk Management** – requirement to refer to Environmental, Social and Governance (ESG) in credit and counterparty policies – with emphasis on counterparty governance (and link across to principles of security, liquidity and yield in that order) remaining paramount. This will be reflected in the revised TMPs;
2. **TMP6 Reporting Requirements & Management Information Arrangements** – requirement that any further investment indicators required by statutory legislation or regulation be reported by Local Authorities as and when they become implemented into statute/regulation. This will be reflected in the revised TMPs;
3. **TMP10 Training & Qualifications: Knowledge and Skills** – strengthened to include a requirement to retain a knowledge and skills register of elected members and employees that includes a training schedule outlining the aims and objectives of training and the expected level of expertise required. This will be reflected in the revised TMPs;
4. **Clear statement in line with Prudential Code** that “Local authorities must not borrow to invest for the primary purpose of financial return.” Midlothian Council does not and has not borrowed to invest primarily for financial return.

5. **Revised definition of Investments** that requires Local Authorities to clearly identify and report the following categories of Investment:-

- Treasury Management Investments;
- Service Investments; and
- Commercial Investments (including Commercial Property).

with the former covered within updated Treasury Management Practices (TMPs) and the latter two in new Investment Management Practices (IMPs).

These new IMPs are required to follow a similar format to the TMPs used for Treasury Management Investments, clearly setting out the investment objectives, criteria, risk management, performance measurement & management, reporting arrangements and ongoing training requirements associated with Service & Commercial Investments.

6. **TMP8 Cash & Cashflow Management:** A new Treasury Management Indicator – the “Liability Benchmark” is required which identifies future borrowing needs against the maturity profile of the Council’s existing loan portfolio.

At the time of writing, further clarity is needed in the CIPFA Treasury Management: Guidance Note regarding the calculation of this.

7. **TMP6 Reporting Requirements** – retention of the existing Treasury Management reporting frequency, which is a minimum of: (a) an annual Strategy report in advance of the forthcoming financial year; (b) a Mid-Year Review report; and (c) An Annual Outturn report after the year-end.

Prudential Code

1. **Prudence:** The Code expands on the detail both of what it considers to be legitimate examples prudence in borrowing and investment, and which acts are not considered to be prudent activity for a Local Authority.

Legitimate examples of prudent borrowing include financing of capital expenditure primarily related to the delivery of a local authority’s functions, temporary management of cashflow within the context of a balanced budget, securing affordability by removing exposure to future interest rate rises, or refinancing current borrowing, including replacing internal borrowing, to manage risk or reflect changing cash flow circumstances.

A key concern for CIPFA continues to be regarding leverage and borrowing to invest particularly for Commercial and Service Investment – with a clear statement in the Prudential Code that

it is “*not prudent to make any investment or spending decision that will increase the capital financing requirement, and so lead to new borrowing, unless directly and primarily related to the functions of the authority and where any financial returns are either related to the financial viability of the project in question or otherwise incidental to the primary purpose*”.

2. **Annual Strategy Review regarding divesting Commercial Investments (including Commercial Property)** – the Prudential Code makes it clear that a Local Authority’s existing commercial investments will not be required to be sold or immediately divested under the provisions of the new Prudential Code.

However, where a Local Authority has an expected need to borrow, the Local Authority should review options for exiting their financial investments for commercial purposes in their annual treasury management or investment strategies.

The options should include using the sale proceeds to repay debt or reduce new borrowing requirements. They should not take new borrowing if financial investments for commercial purposes can reasonably be realised instead, based on a financial appraisal which takes account of financial implications and risk reduction benefits;.

3. **Objectives of the Prudential Code** – updated to cover the following new objectives:
 - Capital plans and investment plans are affordable and proportionate with this based on the judgement of the S95 officer, based on the size and aims of the organisation;
 - All external borrowing/other long-term liabilities are within prudent and sustainable levels. This is already encompassed in the TMIS; and
 - Risks associated with investments for commercial purposes are proportionate to a Local Authority’s overall financial capacity i.e. that plausible losses could be absorbed in budgets or reserves without unmanageable detriment to local services and/or the level of resources available to an organisation. Not applicable for Midlothian Council.
4. **Revised definition of Investments** as covered in Treasury Management Code Item 5 above [shared definition between TM and Prudential Codes];
5. **ESG in Capital Strategy** – requirements of Capital Strategy in Prudential Code broadened, to make clear the Capital Strategy must address environmental sustainability in a manner which is consistent with Councils’ own corporate policies on the issue.

This will encompass the work already being undertaken to meet the Council's commitment to achieving Net Zero by 2030, including the requirements for Passivhaus technology, greater emphasis on active travel and connecting with public transport proposals, and the greater importance on the need for high quality green and blue infrastructure to address issues such as biodiversity and surface water management;

6. **Capital Financing Requirement** – Gross Debt and the Capital Financing Requirement remain a key indicator (see Appendix 2, Section 3.1). Furthermore, the calculation of the Capital Financing Requirement (CFR) must include Heritage Assets. Midlothian Council already include Heritage Assets within the calculation of the CFR;
7. **Reporting & Monitoring of Prudential Indicators:** A requirement for the reporting and monitoring of Prudential Indicators to be provided to Council on at least a quarterly basis;
8. **Inclusion of new Prudential Indicator for Affordability:** Net Income from Service & Commercial Investments as a proportion of the Net Revenue Stream – see Appendix 2, Section 1.3;
9. **Clear statement as also noted in the TM Code** that “Local Authorities must not borrow to invest primarily for financial return.” Midlothian Council does not and has not borrowed to invest primarily for financial return;
10. **Long-Term Treasury Investments:** CIPFA leaves any decision to maintain long term Treasury Investment to each Authority/S95 officer to justify (assumption being that these are not borrowed for) and any longer term Treasury Investment to be linked to Business Model (e.g. a link to cash flow management or treasury risk management).

CIPFA expect Local Authorities to integrate the requirements of the new Treasury Management and Prudential Codes, and the Treasury Management Guidance Note, into their decision-making, monitoring and management.

CIPFA make it clear that the new 2021 Prudential Code applies with immediate effect but that Local Authorities can defer the reporting requirement until the 2023/24 financial year.

CIPFA also make it clear that the new 2021 Treasury Management Code is a “soft launch” with formal adoption and reporting to be required from the 2023/24 financial year. The Treasury Management: Guidance Note which accompanies the Treasury Management Code is expected to be published by CIPFA at the end of January 2022, and is expected to include further detail on the TMPs, IMPs, and calculation and presentation of the new Treasury Management Indicator for the Liability Benchmark.

It is therefore proposed that the implementation of the Codes for Midlothian Council is as follows:-

- Following publication of CIPFA's Treasury Management Guidance Note for Local Authorities, Council officers will update the existing Treasury Management Practices (TMPs), along with development of the new Investment Management Practices (IMPs), to reflect the full requirements of the new Treasury Management [and Prudential] Codes, and bring these back to Audit Committee for scrutiny at the earliest available opportunity.
- The reporting requirements of the Prudential Code requires that the Section 95 officer establish procedures to monitor and report Prudential Indicators on a quarterly basis.

These are already currently reported to Council as part of the Treasury Strategy, Treasury Mid-Year Review, and Annual Treasury Outturn reports.

It is proposed that from the 2022/23 financial year, these are reported to Council as part of the current quarterly financial reporting arrangements.

- Officers will incorporate the new Environmental & Sustainability provisions of the Prudential Code in the next update of the Capital Strategy.

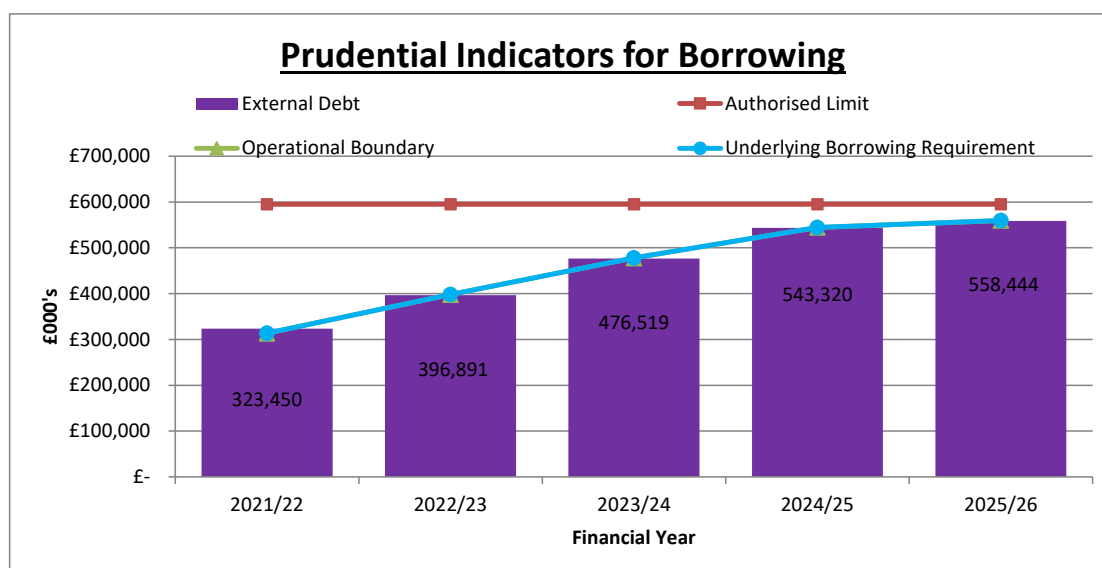
4.2 Prudential Indicators – Midlothian Council

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

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

- Actual outcomes for 2020/21;
- Revised estimates of the 2021/22 indicators; and
- Estimates of indicators for 2022/23 to 2025/26.

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



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

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

The Authorised Limit for Borrowing has been calculated by taking the maximum value of the CFR over this year and the next 4 financial years (2022/23 to 2025/26), with the total forecast level of unrealised capital receipts and developer contributions added back to this figure (given the inherent uncertainty regarding the timing and value of these receipts/contributions). This is shown in table 5 below.

Table 5: Authorised Limit for Borrowing: Calculation

Authorised Limit	Amount £000's
CFR – General Services (31 March 2026)	231,168
CFR – HRA (31 March 2026)	328,466
Forecast Capital Receipts & Developer Contributions 21/22 to 25/26	35,422
Proposed Authorised Limit	595,056

Council is therefore asked to approve an authorised limit for borrowing of £595.056 million, if market conditions support this action. This would have the effect of securing lower costs for future years but care would be taken to ensure that the cost of carry from borrowing early is minimised and that the maturity structure of all debt is sufficiently robust to ensure that the CFR at 31 March 2026 remains achievable.

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

5 Statutory repayment of loans fund advances

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

The TMIS retains the methodology adopted in 2021/22 – that is as follows:-

5.1 New Assets

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

5.2 Prudent Repayment of Loans Fund Advances

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

In line with the policy adopted in 2021/22, the Asset Life method shall be used for those assets in Table 6.

Table 6: Asset Classes to adopt the “Asset Life” method

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

** Average loans fund advance length*

The annual repayments under the “Asset Life” method for those asset classes as noted above will be calculated using the asset lives and will use the annuity method, to ensure consistency of approach with the Statutory method for all other asset classes (see below). The annuity interest rate that will be used to calculate loans fund principal

repayments under the “Asset Life” method will be the in-year loans fund rate, which for 2021/22 is currently estimated to be 2.86%.

For all other asset classes, the policy will be to maintain the practice of previous years and apply what is termed “the Statutory Method” – following the principles of Schedule 3 of the Local Government (Scotland) Act 1975 – with all loans fund advances being repaid by the annuity method. The annuity rate that is proposed to be applied to the loans fund repayments varies will be the in-year loans fund rate, reflecting the Council's current loan and investment portfolio. The loans fund rate for 2021/22 is forecast to be 2.86%

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

6 Performance Indicators 2020/21 – comparison with other Scottish Local Authorities

The Treasury Management Forum collates performance indicators for all Scottish Local Authorities. The indicators relating to financial year 2020/21 have been published and once again demonstrate the continuing effectiveness of the Council's Treasury function in maximising efficiency in Treasury Management activity, with the Council having the 5th lowest weighted average borrowing & investment (loans fund) rate across all Scottish mainland authorities in 2020/21. The Council has consistently maintained the loans fund rate as one of the lowest across all Scottish mainland authorities for the last decade and more. Appendix 3 outlines the loans fund rate for each Scottish Local Authority in 2020/21.

Were the internal loans fund rate to have equated to the Scottish weighted average of 3.55%, this would have generated loan charges in 2020/21 of £17.9m. The Council's actual 2020/21 loan charges for General Services and HRA were £16.5m, representing a cash saving (compared to the Scotland average) of £1.4m in 2020/21.

7. Report Implications

7.1 Resource

There are no direct resource implications arising from this report.

7.2 Digital

None

7.3 Risk

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

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

7.4 Ensuring Equalities

There are no equality issues arising from this report.

7.5 Additional Report Implications

See Appendix A.

Appendix A: Report Implications

A.1 Key Priorities within the Single Midlothian Plan

Not applicable.

A.2 Key Drivers for Change

A.3 Key Delivery Streams

Themes addressed in this report:

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

A.4 Delivering Best Value

The report does not directly impact on Delivering Best Value.

A.5 Involving Communities and Other Stakeholders

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

A.6 Impact on Performance and Outcomes

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

A.7 Adopting a Preventative Approach

Not applicable.

A.8 Supporting Sustainable Development

Not applicable

Background Papers:-

Appendix 1:- Permitted Investments

Appendix 2:- Prudential Indicators

Appendix 3:- Performance Indicators 2020/21

Appendix 4:- Treasury Management & Annual Investment Strategy
Statement – 2022/23 Detailed

Permitted Investments

Appendix 1

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

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

Link Asset Services Colour Code	Maximum Suggested Duration for Investment
Yellow	6 years*
Dark Pink	6 years**
Light Pink	6 years**
Purple	2.5 years
Blue	1.25 years***
Orange	1.25 years
Red	7 months
Green	120 days
No colour	Not to be used

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

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

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

Note that the maximum suggested durations listed above have been extended by 1 year (when compared to the suggested maximum durations provided by Link) for the Yellow, Dark Pink, Light Pink categories (and so to 6 years); the Purple category by 6 months to 2.5 years; the Blue and Orange categories by 3 months to 1.25 years; the Red category by a month to 7 months, and the Green category by 20 days to 120 days. This is 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. A thorough appraisal of the additional risk involved in extending the duration of any deposit (marginally) beyond the maximum suggested by Link, against any enhanced value to the portfolio, will be undertaken prior to the placement of any deposit.

1.1 Deposits

Investment Category	Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period
Debt Management Agency Deposit Facility	--	Term	No	100%	6 months
Term deposits – local authorities	--	Term	No	100%	5 years
Call accounts – banks and building societies	Green	Instant	No	100%	1 day
Term deposits / Notice Accounts – banks and building societies	Yellow Purple Blue Orange Red Green No Colour	Term	No	100%	Up to 6 yrs Up to 2.5 yrs Up to 1.25 yrs Up to 1.25 yrs Up to 7 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 2.5 yrs Up to 1.25 yrs Up to 1.25 yrs Up to 7 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%	1.25 years
UK nationalised banks – Fixed term deposits with variable rate and variable maturities: - Structured deposits	Blue	Term	No	100%	1.25 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 2.5 yrs Up to 1.25 yrs Up to 1.25 yrs Up to 7 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 2.5 yrs Up to 1.25 yrs Up to 1.25 yrs Up to 7 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 week
Ultra Short Dated Bond Funds with a credit score of 1.5	AAA	T+1 to T+5	Yes	100%	1 week
Bond Funds	AAA	T+2 or longer	Yes	50%	2 days
Gilt Funds	AAA	T+2 or longer	Yes	50%	2 days

1.4 Securities issued or guaranteed by governments

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

1.5 Securities issued by corporate organisations

Investment Category	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Certificates of deposit issued by banks and building societies	Yellow Purple Blue Orange Red Green No Colour	Sale T+0	Yes	100%	Up to 6 yrs Up to 2.5 yrs Up to 1.25 yrs Up to 1.25 yrs Up to 7 mths Up to 120 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 2.5 yrs Up to 1.25 yrs Up to 1.25 yrs Up to 7 mths Up to 120 days Not for use
Floating rate notes	Yellow Purple Blue Orange Red Green No Colour	Sale T+2	Yes	100%	Up to 6 yrs Up to 2.5 yrs Up to 1.25 yrs Up to 1.25 yrs Up to 7 mths Up to 120 days Not for use
Corporate Bonds other	Yellow Purple Blue Orange Red Green No Colour	Sale T+2	Yes	100%	Up to 6 yrs Up to 2.5 yrs Up to 1.25 yrs Up to 1.25 yrs Up to 7 mths Up to 120 days Not for use

1.6 Other

Investment Category	Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period
Local authority mortgage guarantee scheme.	Blue	Term	No	50%	5 years
Loans to Third Parties	n/a	Term	No	£25m	25 years
Subordinated Debt Subscription to Newbattle Centre SPV	n/a	Term	No	£0.326m	22 years
ESCO	n/a	Term	No	£10.2m	n/a

Treasury Risks and Mitigating Controls for each type of investment are as outlined in the Treasury Management & Annual Investment Strategy Statement – 2022/23 Detailed – Appendix 5.3.

1. Prudential Indicators for Affordability

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

1.1 Estimates of Ratio of Financing Costs to Net Revenue Stream

This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

Table 5: Ratio of Financing Costs to Net Revenue Stream						
%	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
General Services	2.03%	1.92%	2.75%	2.86%	2.97%	3.08%
HRA	38.86%	39.10%	43.76%	48.70%	49.33%	50.25%

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

1.2 HRA Ratios

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

HRA Debt as a % of Gross Revenue						
	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
HRA debt £000's	£ 172,394	£ 173,729	£ 233,729	£ 287,880	£ 325,373	£ 328,466
HRA revenues £000's	£ 30,004	£ 30,562	£ 30,625	£ 33,159	£ 34,747	£ 35,716
Ratio of debt to revenues %	575%	568%	763%	868%	936%	920%

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

HRA Debt per Dwelling						
	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
HRA debt £000's	£ 172,394	£ 173,729	£ 233,729	£ 287,880	£ 325,373	£ 328,466
Number of HRA dwellings	7,002	7,168	7,437	7,904	8,217	8,229
Debt per dwelling £	£ 24,621	£ 24,237	£ 31,428	£ 36,422	£ 39,598	£ 39,916

1.3 Net Income from Service & Commercial Investments as a proportion of Net Revenue Stream

A new indicator will be developed as part of the implementation of the new Prudential Code which identifies the ratio of net income from service and commercial investments as a proportion of the net General Services revenue stream.

2. Prudential Indicators for Capital Expenditure

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

2.1 Estimated Capital Expenditure

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

Capital Expenditure						
	2020/21 Actual £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's	2025/26 Estimate £000's
General Services						
Place	£ 14,709	£ 25,591	£ 33,439	£ 18,998	£ 11,359	£ 12,422
People & Partnerships	£ 10,780	£ 14,075	£ 23,585	£ 33,406	£ 30,190	£ 17,159
Council Transformation	£ 69	£ 801	£ 867	£ 7,548	£ 12,764	£ -
Provision for Return of Contingencies	£ -	£ (639)	£ (1,213)	£ (1,396)	£ (1,490)	£ (1,503)
Total General Services	£ 25,558	£ 39,828	£ 56,678	£ 58,556	£ 52,823	£ 28,078
Total HRA	£ 15,632	£ 35,930	£ 82,868	£ 72,346	£ 46,021	£ 12,321
Combined Total	£ 41,190	£ 75,758	£ 139,546	£ 130,902	£ 98,844	£ 40,399

2.2 Financing of Capital Expenditure

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

Capital Expenditure and Available Financing						
	2020/21 Actual £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's	2025/26 Estimate £000's
Capital Expenditure						
General Services	£ 25,558	£ 39,828	£ 56,678	£ 58,556	£ 52,823	£ 28,078
HRA	£ 15,632	£ 35,930	£ 82,868	£ 72,346	£ 46,021	£ 12,321
Total	£ 41,190	£ 75,758	£ 139,546	£ 130,902	£ 98,844	£ 40,399
Financed by:						
Capital receipts	£ 998	£ 72	£ -	£ -	£ -	£ -
Capital grants	£ 20,194	£ 16,741	£ 22,250	£ 24,484	£ 12,234	£ 10,479
Capital reserves	£ -	£ 27,000	£ 8,704	£ 9,242	£ 7,694	£ -
Developer/Other Contributions	£ 3,661	£ 2,689	£ 14,883	£ 11,578	£ 4,115	£ 2,084
Net financing need for the year	£ 16,337	£ 29,256	£ 93,709	£ 85,599	£ 74,801	£ 27,835

2.3 Estimated Capital Financing Requirement

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

Capital Financing Requirement (CFR)						
	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's	£000's
Capital Financing Requirement						
CFR – General Services	£ 119,929	£ 139,917	£ 164,352	£ 189,829	£ 219,137	£ 231,168
CFR – HRA	£ 172,394	£ 173,729	£ 233,729	£ 287,880	£ 325,373	£ 328,466
CFR – PFI Schemes	£ 99,203	£ 95,914	£ 92,433	£ 88,739	£ 84,815	£ 80,661
Total CFR	£ 391,526	£ 409,560	£ 490,514	£ 566,448	£ 629,325	£ 640,295
Movement in CFR	£ (2,376)	£ 18,034	£ 80,954	£ 75,934	£ 62,877	£ 10,970
Movement in CFR represented by						
Net financing need for the year (previous table)	£ 16,337	£ 29,256	£ 93,709	£ 85,599	£ 74,801	£ 27,835
Less Scheduled Debt Amortisation	£ (8,170)	£ (9,123)	£ (9,594)	£ (10,781)	£ (11,870)	£ (12,711)
Less net PFI Finance Lease Principal Payments	£ (10,543)	£ (3,289)	£ (3,481)	£ (3,694)	£ (3,924)	£ (4,154)
Movement in CFR	£ (2,376)	£ 18,034	£ 80,954	£ 75,934	£ 62,877	£ 10,970

3. Prudential Indicators for Prudence

3.1 Net Borrowing Requirement

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

Net Borrowing Requirement						
	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's	£000's
External Debt						
Debt at 1 April	£ 269,077	£ 274,795	£ 323,450	£ 398,081	£ 477,709	£ 544,510
Actual/Expected change in Debt	£ 5,718	£ 48,655	£ 74,631	£ 79,628	£ 66,801	£ 15,124
Other long-term liabilities (OLTL)	£ 109,746	£ 99,203	£ 95,914	£ 92,433	£ 88,739	£ 84,815
Actual/Expected change in OLTL	£ (10,543)	£ (3,289)	£ (3,481)	£ (3,694)	£ (3,924)	£ (4,154)
Actual/Expected Gross Debt at 31 March	£ 373,998	£ 419,364	£ 490,514	£ 566,448	£ 629,325	£ 640,295
The Capital Financing Requirement	£ 391,526	£ 409,560	£ 490,514	£ 566,448	£ 629,325	£ 640,295
Under / (over) borrowing	£ 17,528	£ (9,804)	£ -	£ -	£ -	£ -
Deposits						
Cash & Cash Equivalents	£ 56,287	£ 65,000	£ 10,000	£ 10,000	£ 10,000	£ 10,000
Short-Term Investments	£ 74,985	£ 70,000	£ 69,985	£ 69,985	£ 59,985	£ 59,985
Total Deposits	£ 131,272	£ 135,000	£ 79,985	£ 79,985	£ 69,985	£ 69,985

4. Prudential Indicators for External Debt

4.1 Operational Boundary

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

For this Council:-

- the Operational Boundary for Borrowing has been calculated to equate directly to the value of the CFR for General Services and HRA combined, over the current financial year and the following 4 financial years (2021/22 to 2025/26); and
- the Operational Boundary for Other Long-Term Liabilities has been calculated to equate directly to the in-year CFR for Other Long-Term Liabilities, given the known contractual provisions for the repayment of debt within the Council's two PPP agreements.

Operational Boundary					
	2021/22	2022/23	2023/24	2024/25	2025/26
	Estimate	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's
Operational Boundary - Borrowing	£ 313,646	£ 398,081	£ 477,709	£ 544,510	£ 559,634
Operational Boundary - Other long term liabilities	£ 95,914	£ 92,433	£ 88,739	£ 84,815	£ 80,661
Total	£ 409,560	£ 490,514	£ 566,448	£ 629,325	£ 640,295

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

4.2 Authorised Limit of Total External Debt

This indicator sets the limit for total external debt.

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

In order to continue to service the ongoing external debt and finance the current capital programmes the Council needs to increase its external borrowing to £559.634 million by 31 March 2026. Within the Capital Plans, there are assumptions regarding capital receipts and developer contributions which when applied to the Council's capital plans reduce the Council's borrowing requirements. However, the realisation of these capital receipts and developer contributions carry inherent uncertainty around both the timing and value of each receipt/contribution, given that they are largely dependent upon economic and market activity which are outwith the Council's control. Therefore, in order to calculate the Authorised Limit for Borrowing, these capital receipts and developer contributions have been added to the Capital Financing Requirement, to give the Council flexibility to fully borrow in advance of need (if market conditions support this action) should these receipts and contributions be unable to be realised in the short term. This therefore reflects a level of borrowing which, while not desired, could be afforded but is not sustainable.

It is expected that, given current market conditions, no borrowing in advance of need for the remainder of 2021/22 and throughout 2022/23 will be undertaken, and that all borrowing undertaken in these periods will be aligned to match as closely as possible to the incurrence of capital expenditure in the remainder of 2021/22 and throughout 2022/23. Should market conditions materially change and which would support any borrowing in advance of need, any

borrowing drawn would be supported by a business case which will appraise the anticipated savings in borrowing costs (from expected increases in rates later in the year / in forthcoming years) against the carrying cost associated with borrowing in advance of need.

Council is therefore asked to approve that, rather than restrict borrowing to £313.646 million for 2021/22, £398.081 million for 2022/23, £477.709 million for 2023/24, £544.510 million for 2024/25, and £559.634 million for 2025/26, that permission be granted to borrow up to the 2025/26 Authorised Limit for Borrowing of £595.056 million as shown in the table below), if market conditions support this action.

Adopting this approach will secure lower costs for future years but care will be taken to ensure that the cost of carry is minimised and that the maturity structure of all debt is sufficiently robust to ensure that the Capital Financing Requirement at 31 March 2026 remains achievable.

Authorised Limit					
	2021/22	2022/23	2023/24	2024/25	2025/26
	Estimate	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's
Authorised Limit - Borrowing	£ 595,056	£ 595,056	£ 595,056	£ 595,056	£ 595,056
Authorised Limit - Other long term liabilities	£ 95,914	£ 92,433	£ 88,739	£ 84,815	£ 80,661
Total Debt	£ 690,970	£ 687,489	£ 683,795	£ 679,871	£ 675,717

Reconciliation of calculation of Authorised Limit for borrowing:-

Reconciliation of Authorised Limit for Borrowing	
	£000's
CFR - General Services at 31 March 2026	£ 231,168
CFR - HRA at 31 March 2026	£ 328,466
Capital Receipts 21/22 to 25/26 unrealised to date	£ 72
Developer/Other Contributions 21/22 to 25/26 unrealised to date	£ 35,349
Authorised Limit for Borrowing	£ 595,056

5. Prudential Indicators for Treasury Management

5.1 Upper limits on Fixed and Variable Interest Rates

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

Upper Limits on Exposure to Fixed and Variable Interest Rates 2022/23			
Interest rate exposures			Upper Limit
Limits on fixed interest rates based on gross debt			100.00%
Limits on variable interest rates based on gross debt			30.00%
Limits on fixed interest rates based on investments			100.00%
Limits on variable interest rates based on investments			100.00%

5.2 Maturity Structure of Borrowing

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

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

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

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

Maturity Structure of Borrowing 2022/23		
Maturity structure of fixed interest rate borrowing 2022/23	Lower	Upper
Under 12 months	0.00%	50.00%
12 months to 2 years	0.00%	50.00%
2 years to 5 years	0.00%	50.00%
5 years to 10 years	0.00%	50.00%
10 years to 20 years	0.00%	50.00%
20 years to 30 years	0.00%	50.00%
30 years to 40 years	0.00%	50.00%
40 years to 50 years	0.00%	50.00%
50 years and above	0.00%	50.00%
Maturity structure of variable interest rate borrowing 2021/22	Lower	Upper
<i>Under 12 months</i>	0.00%	30.00%
<i>12 months to 2 years</i>	0.00%	30.00%
<i>2 years to 5 years</i>	0.00%	30.00%
<i>5 years to 10 years</i>	0.00%	30.00%
<i>10 years to 20 years</i>	0.00%	30.00%
<i>20 years to 30 years</i>	0.00%	30.00%
<i>30 years to 40 years</i>	0.00%	30.00%
<i>40 years to 50 years</i>	0.00%	30.00%
<i>50 years and above</i>	0.00%	30.00%

5.4 Total Principal Sums Invested for Periods Longer than 365 Days

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

Principal Sums Invested for > 365 Days		
Limit		£70m

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

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

5.5 Liability Benchmark

A new indicator will be developed as part of the implementation of the new Treasury Management Code which identifies future borrowing needs against the maturity profile of the Council's existing loan portfolio.

Authority	Loans Fund Rate
West Dunbartonshire	2.29%
Aberdeenshire	2.66%
North Lanarkshire	3.03%
East Lothian	3.05%
Midlothian	3.10%
Dumfries & Galloway	3.14%
Perth & Kinross	3.15%
East Dunbartonshire	3.21%
Argyll & Bute	3.41%
Inverclyde	3.42%
East Ayrshire	3.50%
Falkirk	3.52%
Fife	3.53%
Dundee City	3.54%
Aberdeen City	3.58%
Renfrewshire	3.59%
South Ayrshire	3.64%
East Renfrewshire	3.67%
Scottish Borders	3.67%
Glasgow City	3.73%
Highland	3.73%
West Lothian	3.75%
Moray	3.87%
Stirling	3.87%
North Ayrshire	3.92%
Edinburgh City	4.26%
Angus	4.57%
Clackmannanshire	5.06%

Treasury Management Strategy Statement and Annual Investment Strategy

Midlothian Council
2022/23

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1 INTRODUCTION

1.1 Background

The main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure that the Council can meet its capital spending obligations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. As such, the second 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 deposited with low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return.

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

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

CIPFA defines treasury management as:

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

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

1.2 Reporting requirements

1.2.1 Capital Strategy

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

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

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

1.2.2 Treasury Management Reporting

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

- a) **Prudential and treasury indicators and treasury strategy** (this report) - The first, and most important report covers:
 - the capital plans (including prudential indicators) for 2021/22 to 2025/26;
 - a policy for the statutory repayment of debt, (how residual capital expenditure is charged to revenue over time);
 - the treasury management strategy (how the investments and borrowings are to be organised) for 2022/23, including treasury indicators; and
 - a permitted investment strategy for 2022/23 (the parameters on how investments are to be managed).
- b) **A mid year treasury management report** – This will update members with the progress of the capital position, amending prudential indicators as necessary, and whether the actual treasury strategy is meeting the strategy outlined in advance of the year, or whether any policies require revision.
- c) **An annual treasury outturn report** – This provides details of a selection of actual prudential and treasury indicators for the previous financial year and actual treasury operations compared to the estimates within the strategy.

Scrutiny

The above reports are required to be adequately scrutinised before being recommended to the Council. This role is undertaken by the Audit Committee with this report being presented to Audit Committee prior to consideration by Council. Any revisions arising from Audit Committee consideration of the report on 25 January 2022 will be incorporated into the final version of the report to Council on 15 February 2022.

1.3 Treasury Management Strategy for 2022/23

The strategy for 2022/23 covers two main areas:

Capital issues

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

Treasury management issues

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

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

1.4 Training

The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsible for scrutiny. A training workshop for Members was held on 5 November 2019, and a Treasury Management Briefing session for all Elected Members and Members of the Audit Committee took place on 17 February 2021. 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 Group, Treasury Solutions, took place on 3 March 2016.

1.5 Treasury management consultants

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

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

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

2 THE CAPITAL PRUDENTIAL INDICATORS 2021/22 – 2025/26

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						
	2020/21 Actual £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's	2025/26 Estimate £000's
General Services						
Place	£ 14,709	£ 25,591	£ 33,439	£ 18,998	£ 11,359	£ 12,422
People & Partnerships	£ 10,780	£ 14,075	£ 23,585	£ 33,406	£ 30,190	£ 17,159
Council Transformation	£ 69	£ 801	£ 867	£ 7,548	£ 12,764	£ -
Provision for Return of Contingencies	£ -	£ (639)	£ (1,213)	£ (1,396)	£ (1,490)	£ (1,503)
Total General Services	£ 25,558	£ 39,828	£ 56,678	£ 58,556	£ 52,823	£ 28,078
Total HRA	£ 15,632	£ 35,930	£ 82,868	£ 72,346	£ 46,021	£ 12,321
Combined Total	£ 41,190	£ 75,758	£ 139,546	£ 130,902	£ 98,844	£ 40,399

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						
	2020/21 Actual £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's	2025/26 Estimate £000's
Capital Expenditure						
General Services	£ 25,558	£ 39,828	£ 56,678	£ 58,556	£ 52,823	£ 28,078
HRA	£ 15,632	£ 35,930	£ 82,868	£ 72,346	£ 46,021	£ 12,321
Total	£ 41,190	£ 75,758	£ 139,546	£ 130,902	£ 98,844	£ 40,399
Financed by:						
Capital receipts	£ 998	£ 72	£ -	£ -	£ -	£ -
Capital grants	£ 20,194	£ 16,741	£ 22,250	£ 24,484	£ 12,234	£ 10,479
Capital reserves	£ -	£ 27,000	£ 8,704	£ 9,242	£ 7,694	£ -
Developer/Other Contributions	£ 3,661	£ 2,689	£ 14,883	£ 11,578	£ 4,115	£ 2,084
Net financing need for the year	£ 16,337	£ 29,256	£ 93,709	£ 85,599	£ 74,801	£ 27,835

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

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

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

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

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

Table 3: Capital Financing Requirement (CFR)						
	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's	£000's
Capital Financing Requirement						
CFR – General Services	£ 119,929	£ 139,917	£ 164,352	£ 189,829	£ 219,137	£ 231,168
CFR – HRA	£ 172,394	£ 173,729	£ 233,729	£ 287,880	£ 325,373	£ 328,466
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Total CFR	£ 391,526	£ 409,560	£ 490,514	£ 566,448	£ 629,325	£ 640,295
Movement in CFR	£ (2,376)	£ 18,034	£ 80,954	£ 75,934	£ 62,877	£ 10,970
Movement in CFR represented by						
Net financing need for the year (previous table)	£ 16,337	£ 29,256	£ 93,709	£ 85,599	£ 74,801	£ 27,835
Less Scheduled Debt Amortisation	£ (8,170)	£ (9,123)	£ (9,594)	£ (10,781)	£ (11,870)	£ (12,711)
Less net PFI Finance Lease Principal Payments	£ (10,543)	£ (3,289)	£ (3,481)	£ (3,694)	£ (3,924)	£ (4,154)
Movement in CFR	£ (2,376)	£ 16,844	£ 80,634	£ 71,124	£ 59,007	£ 10,970

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

2.3 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 and anticipated day-to-day cash flow balances.

Table 4: Balance Sheet Resources						
Reserve	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's	£000's
HRA Balances	£ 48,385	£ 28,763	£ 26,823	£ 22,197	£ 23,538	£ 24,307
General Fund Balances	£ 3,812	£ 3,812	£ 3,650	£ 3,650	£ 3,650	£ 3,650
Earmarked reserves	£ 25,859	£ 12,930	£ -	£ -	£ -	£ -
Provisions	£ 3,897	£ 3,236	£ 3,214	£ 2,787	£ 2,600	£ 2,500
Capital Fund	£ 24,158	£ 23,703	£ 20,703	£ 18,170	£ 10,476	£ 8,607
Total Reserves / Core Funds	£ 106,111	£ 72,444	£ 54,390	£ 46,804	£ 40,264	£ 39,064
Working capital*	£ 42,689	£ 52,753	£ 25,595	£ 33,181	£ 29,721	£ 30,921
Under/over borrowing	£ 17,528	£ (9,804)	£ -	£ -	£ -	£ -
Expected investments	£ 131,272	£ 135,000	£ 79,985	£ 79,985	£ 69,985	£ 69,985

*Working capital balances shown are estimated year-end; these may be higher mid-year

2.3 Statutory repayment of loans fund advances

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

It is proposed to retain the methodology adopted in 2021/22 – that is as follows:-

New Assets

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

Prudent Repayment of Loans Fund Advances

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

In line with the policy adopted in 2021/22, the Asset Life method shall be used for those assets in Table 6.

Table 5: Asset Classes to adopt the “Asset Life” method

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

** Average loans fund advance length*

The annual repayments under the “Asset Life” method for those asset classes as noted above will be calculated using the asset lives and will use the annuity method, to ensure consistency of approach with the Statutory method for all other asset classes (see below). The annuity interest rate that will be used to calculate loans fund principal repayments under the “Asset Life” method will be the in-year loans fund rate, which for 2021/22 is currently estimated to be 2.86%.

For all other asset classes, the policy will be to maintain the practice of previous years and apply what is termed “the Statutory Method” – following the principles of Schedule 3 of the Local Government (Scotland) Act 1975 – with all loans fund advances being repaid by the annuity method. The annuity rate that is proposed to be applied to the loans fund repayments varies will be the in-year loans fund rate, reflecting the Council’s current loan and investment portfolio. The loans fund rate for 2021/22 is forecast to be 2.86%

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

3 Borrowing

The capital expenditure plans set out in Section 2 provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the 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 Treasury management portfolio position

The overall treasury management portfolio as at 31 March 2021 and for the position as at 7 January 2022 are shown below for both borrowing and investments.

Table 6: Portfolio Position 31 March 2021 and 7 January 2022

Loan Type	31 March 2021		7 January 2022	
	Principal Outstanding £000's	Weighted Average Rate	Principal Outstanding £000's	Weighted Average Rate
PWLB Annuity	597	8.90%	553	8.90%
PWLB Maturity	235,424	3.28%	284,776	2.70%
LOBO	20,000	4.51%	20,000	4.51%
Market Loans	18,191	2.68%	17,721	2.68%
Salix Loans	583	0.00%	400	0.00%
Total Loans	274,795	3.34%	323,450	2.81%
Deposit Type	31 March 2021		7 January 2022	
	Principal Outstanding £000's	Weighted Average Rate	Principal Outstanding £000's	Weighted Average Rate
Bank Call Accounts	26,470	0.01%	17,226	0.05%
Money Market Funds	29,817	0.01%	37,919	0.04%
Bank Notice Accounts	14,985	0.58%	14,985	0.58%
Bank Fixed Term Deposits	-	n/a	35,000	n/a
Other Local Authorities	60,000	1.62%	60,000	1.62%
Total Deposits	131,272	0.81%	165,130	0.74%

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

Table 7: Net Borrowing Requirement						
	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's	£000's
External Debt						
Debt at 1 April	£ 269,077	£ 274,795	£ 323,450	£ 398,081	£ 477,709	£ 544,510
Actual/Expected change in Debt	£ 5,718	£ 48,655	£ 74,631	£ 79,628	£ 66,801	£ 15,124
Other long-term liabilities (OLTL) at 1 April	£ 109,746	£ 99,203	£ 95,914	£ 92,433	£ 88,739	£ 84,815
Actual/Expected change in OLTL	£ (10,543)	£ (3,289)	£ (3,481)	£ (3,694)	£ (3,924)	£ (4,154)
Actual/Expected Gross Debt at 31 March	£ 373,998	£ 419,364	£ 490,514	£ 566,448	£ 629,325	£ 640,295
The Capital Financing Requirement	£ 391,526	£ 409,560	£ 490,514	£ 566,448	£ 629,325	£ 640,295
Under / (over) borrowing	£ 17,528	£ (9,804)	£ -	£ -	£ -	£ -
Deposits						
Cash & Cash Equivalents	£ 56,287	£ 65,000	£ 10,000	£ 10,000	£ 10,000	£ 10,000
Short-Term Investments	£ 74,985	£ 70,000	£ 69,985	£ 69,985	£ 59,985	£ 59,985
Total Deposits	£ 131,272	£ 135,000	£ 79,985	£ 79,985	£ 69,985	£ 69,985

Within the range of prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well-defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2022/23 and the following three financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

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

3.2 Treasury Indicators: limits to borrowing activity

The operational boundary

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

For this Council:-

- the Operational Boundary for Borrowing has been calculated to equate directly to the in-year value of the CFR over the current and following 4 financial years (2021/22 to 2025/26); 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 8: Operational Boundary					
	2021/22	2022/23	2023/24	2024/25	2025/26
	Estimate	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's
Operational Boundary - Borrowing	£313,646	£398,081	£477,709	£544,510	£559,634
Operational Boundary - Other long term liabilities	£95,914	£92,433	£88,739	£84,815	£80,661
Total	£409,560	£490,514	£566,448	£629,325	£640,295

The authorised limit for external debt

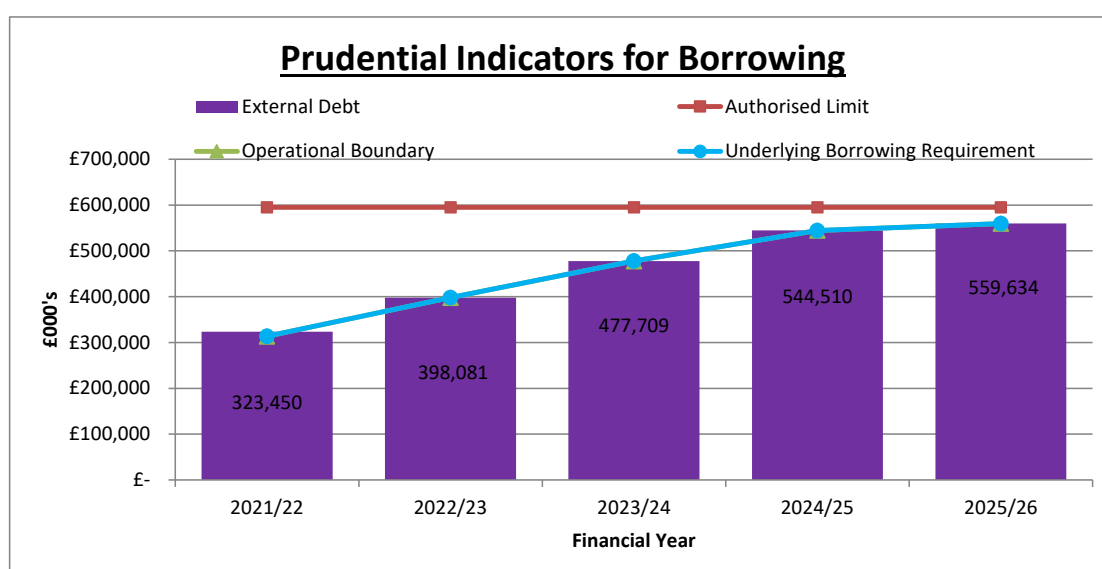
A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external debt which, while not desired, could be afforded 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 (2022/23 to 2025/26), 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 £313.646 million for 2021/22, £398.081 million for 2022/23, £477.709 million for 2023/24, £544.510 million for 2024/25, and £559.634 million for 2025/26, that permission be granted to borrow up to the 2025/26 Authorised Limit for Borrowing of £595.056 million as shown in the table below), if market conditions support this action;
 - b. Should market conditions support any borrowing in advance of need, any borrowing drawn would be supported by a business case which will appraise the anticipated savings in borrowing costs (from expected increases in rates later in the year / in forthcoming years) against the carrying cost associated with borrowing in advance of need
 - c. This would have the effect of securing lower costs for future years but care would be taken to ensure that the cost of carry from borrowing early is minimized and that the maturity structure of all debt is sufficiently robust to ensure that the CFR at 31 March 2026 remains achievable.

- d. The authorised limit therefore reflects a level of borrowing which, while not desired, could be afforded but is not sustainable.
3. The Authorised Limit for Other Long-Term Liabilities has been calculated to equate directly to the Operational Boundary for Other Long-Term Liabilities, given the known contractual provisions for the repayment of debt within the Council's four DBFM agreements.

Table 9: Authorised Limit					
	2021/22	2022/23	2023/24	2024/25	2025/26
	Estimate	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's
Authorised Limit - Borrowing	£ 595,056	£ 595,056	£ 595,056	£ 595,056	£ 595,056
Authorised Limit - Other long term liabilities	£ 95,914	£ 92,433	£ 88,739	£ 84,815	£ 80,661
Total Debt	£ 690,970	£ 687,489	£ 683,795	£ 679,871	£ 675,717

Reconciliation of Authorised Limit for Borrowing	
	£000's
CFR - General Services at 31 March 2026	£ 231,168
CFR - HRA at 31 March 2026	£ 328,466
Capital Receipts 21/22 to 25/26 unrealised to date	£ 72
Developer/Other Contributions 21/22 to 25/26 unrealised to date	£ 35,349
Authorised Limit for Borrowing	£ 595,056



3.3 Prospects for interest rates

The Council has appointed Link Group, Treasury Solutions as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. Link provided the following forecasts on 20th December 2021. These are forecasts for certainty rates, gilt yields plus 80 bps.

Link Group Interest Rate View 20.12.21														
	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25
BANK RATE	0.25	0.25	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25
3 month ave earnings	0.20	0.30	0.50	0.50	0.60	0.70	0.80	0.90	0.90	1.00	1.00	1.00	1.00	1.00
6 month ave earnings	0.40	0.50	0.60	0.60	0.70	0.80	0.90	1.00	1.00	1.10	1.10	1.10	1.10	1.10
12 month ave earnings	0.70	0.70	0.70	0.70	0.80	0.90	1.00	1.10	1.10	1.20	1.20	1.20	1.20	1.20
5 yr PWLB	1.40	1.50	1.50	1.60	1.60	1.70	1.80	1.80	1.80	1.90	1.90	1.90	2.00	2.00
10 yr PWLB	1.60	1.70	1.80	1.80	1.90	1.90	2.00	2.00	2.00	2.10	2.10	2.10	2.20	2.30
25 yr PWLB	1.80	1.90	2.00	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.40	2.40	2.50	2.50
50 yr PWLB	1.50	1.70	1.80	1.90	1.90	2.00	2.00	2.00	2.10	2.10	2.20	2.20	2.30	2.30

Over the last two years, the coronavirus outbreak has done huge economic damage to the UK and to economies around the world. After the Bank of England took emergency action in March 2020 to cut Bank Rate to 0.10%, it left Bank Rate unchanged at its subsequent meetings until raising it to 0.25% at its meeting on 16th December 2021.

As shown in the forecast table above, the forecast for Bank Rate now includes four increases, one in December 2021 to 0.25%, then quarter 2 of 2022 to 0.50%, quarter 1 of 2023 to 0.75%, quarter 1 of 2024 to 1.00% and, finally, one in quarter 1 of 2025 to 1.25%.

Significant risks to the forecasts:-

- **Mutations** of the virus render current vaccines ineffective, and tweaked vaccines to combat these mutations are delayed, or cannot be administered fast enough to prevent further lockdowns. 25% of the population not being vaccinated is also a significant risk to the NHS being overwhelmed and lockdowns being the only remaining option.
- **Labour and supply shortages** prove more enduring and disruptive and depress economic activity.
- **The Monetary Policy Committee** acts too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- **The Monetary Policy Committee** tightens monetary policy too late to ward off building inflationary pressures.
- **The Government** acts too quickly to cut expenditure to balance the national budget.
- **UK / EU trade arrangements** – if there was a major impact on trade flows and financial services due to complications or lack of co-operation in sorting out significant remaining issues.
- **Longer term US treasury yields** rise strongly and pull gilt yields up higher than forecast.
- **Major stock markets** e.g., in the US, become increasingly judged as being over-valued and susceptible to major price corrections. Central banks become increasingly exposed to the “moral hazard” risks of having to buy shares and corporate bonds to reduce the impact of major financial market selloffs on the general economy.
- **Geopolitical risks**, for example in Ukraine, Iran, North Korea, but also in Europe and Middle Eastern countries; on-going global power influence struggles between Russia/China/US. These could lead to increasing safe-haven flows.

The balance of risks to the UK economy:-

- The overall balance of risks to economic growth in the UK is now to the downside, including risks from Covid and its variants - both domestically and their potential effects worldwide.

Forecasts for Bank Rate

It is not expected that Bank Rate will go up fast after the initial rate rise as the supply potential of the economy is not likely to have taken a major hit during the pandemic: it should, therefore, be able to cope well with meeting demand after supply shortages subside over the next year, without causing inflation to remain elevated in the medium-term, or to inhibit inflation from falling back towards the MPC's 2% target after the spike up to around 5%. The forecast includes four increases in Bank Rate over the three-year forecast period to March 2025, ending at 1.25%. However, it is likely that these forecasts will need changing within a relatively short timeframe for the following reasons:-

- We do not know how severe an impact Omicron could have on the economy and whether there will be another lockdown or similar and, if there is, whether there would be significant fiscal support from the Government for businesses and jobs.
- There were already increasing grounds for viewing the economic recovery as running out of steam during the autumn and now into the winter. And then along came Omicron to pose a significant downside threat to economic activity. This could lead into stagflation, or even into recession, which would then pose a dilemma for the MPC as to whether to focus on combating inflation or supporting economic growth through keeping interest rates low.
- Will some current key supply shortages spill over into causing economic activity in some sectors to take a significant hit?
- Rising gas and electricity prices in October and next April and increases in other prices caused by supply shortages and increases in taxation next April, are already going to deflate consumer spending power without the MPC having to take any action on Bank Rate to cool inflation.
- On the other hand, consumers are sitting on over £160bn of excess savings left over from the pandemic so when will they spend this sum, in part or in total?
- It looks as if the economy coped well with the end of furlough on 30th September. It is estimated that there were around 1 million people who came off furlough then and there was not a huge spike up in unemployment. The other side of the coin is that vacancies have been hitting record levels so there is a continuing acute shortage of workers. This is a potential danger area if this shortage drives up wages which then feed through into producer prices and the prices of services i.e., a second-round effect that the MPC would have to act against if it looked like gaining significant momentum.
- We also recognise there could be further nasty surprises on the Covid front beyond the Omicron mutation.
- If the UK invokes article 16 of the Brexit deal over the dislocation in trading arrangements with Northern Ireland, this has the potential to end up in a no-deal Brexit.

In summary, with the high level of uncertainty prevailing on several different fronts, Link Group expect to revise their forecasts again.

It should also be borne in mind that Bank Rate being cut to 0.25% and then to 0.10%, were emergency measures to deal with the Covid crisis hitting the UK in March 2020. At any time, the MPC could decide to simply take away such emergency cuts on no other grounds than they are no longer warranted, and as a step forward in the return

to normalisation. In addition, any Bank Rate under 1% is both highly unusual and highly supportive of economic growth.

Forecasts for PWLB rates and gilt and treasury yields

Since the start of 2021, we have seen a lot of volatility in gilt yields, and hence PWLB rates. As the interest forecast table for PWLB certainty rates above shows, there is forecast to be a steady, but slow, rise in both Bank Rate and gilt yields during the forecast period to March 2025, though there will doubtless be a lot of unpredictable volatility during this forecast period.

While monetary policy in the UK will have a major impact on gilt yields, there is also a need to consider the potential impact that rising treasury yields in America could have on our gilt yields. **As an average since 2011, there has been a 75% correlation between movements in US 10-year treasury yields and UK 10-year gilt yields. This is a significant UPWARD RISK exposure to our forecasts for longer term PWLB rates. However, gilt yields and treasury yields do not always move in unison.**

US treasury yields

During the first part of 2021, US President Biden's, and the Democratic party's, determination to push through a \$1.9trn (equivalent to 8.8% of GDP) fiscal boost for the US economy as a recovery package from the Covid pandemic was what unsettled financial markets. However, this was in addition to the \$900bn support package already passed in December 2020. This was then followed by additional Democratic ambition to spend \$1trn on infrastructure, (which was eventually passed by both houses later in 2021), and an even larger sum on an American families plan over the next decade; this is still caught up in Democrat / Republican haggling. Financial markets were alarmed that all this stimulus was happening at a time when: -

1. A fast vaccination programme had enabled a rapid opening up of the economy during 2021.
2. The economy was growing strongly during the first half of 2021 although it has weakened overall during the second half.
3. It started from a position of little spare capacity due to less severe lockdown measures than in many other countries.
4. And the Fed was still providing substantial stimulus through monthly QE purchases during 2021.

It was not much of a surprise that a combination of these factors would eventually cause an excess of demand in the economy which generated strong inflationary pressures. This has eventually been recognised by the Fed at its December meeting with an aggressive response to damp inflation down during 2022 and 2023.

At its 3rd November Fed meeting, the Fed decided to make a start on tapering its \$120bn per month of QE purchases so that they ended next June. However, at its **15th December meeting** it doubled the pace of tapering so that they will end all purchases in February. These purchases are currently acting as downward pressure on treasury yields and so it would be expected that Treasury yields will rise over the taper period and after the taper ends, all other things being equal. The Fed also forecast that it expected there would be three rate rises in 2022 of 0.25% from near zero currently, followed by three in 2023 and two in 2024, taking rates back above 2% to a neutral level for monetary policy.

There are also possible **DOWNSIDE RISKS** from the huge sums of cash that the UK populace have saved during the pandemic; when savings accounts earn little interest, it is likely that some of this cash mountain could end up being invested in bonds and so push up demand for bonds and support their prices i.e., this would help to keep their

yields down. How this will interplay with the Bank of England eventually getting round to not reinvesting maturing gilts and then later selling gilts, will be interesting to monitor.

There is likely to be **exceptional volatility and unpredictability in respect of gilt yields and PWLB rates** due to the following factors:-

- How strongly will changes in gilt yields be correlated to changes in US treasury yields? Over 10 years since 2011 there has been an average 75% correlation between movements in US treasury yields and gilt yields. However, from time to time these two yields can diverge. Lack of spare economic capacity and rising inflationary pressures are viewed as being much greater dangers in the US than in the UK. This could mean that central bank rates will end up rising earlier and higher in the US than in the UK if inflationary pressures were to escalate; the consequent increases in treasury yields could well spill over to cause (lesser) increases in gilt yields. There is, therefore, an upside risk to forecasts for gilt yields due to this correlation. The Link Group forecasts have included a risk of a 75% correlation between the two yields.
- Will the Fed take action to counter increasing treasury yields if they rise beyond a yet unspecified level?
- Would the MPC act to counter increasing gilt yields if they rise beyond a yet unspecified level?
- How strong will inflationary pressures actually turn out to be in both the US and the UK and so put upward pressure on treasury and gilt yields?
- How will central banks implement their new average or sustainable level inflation monetary policies?
- How well will central banks manage the withdrawal of QE purchases of their national bonds i.e., without causing a panic reaction in financial markets as happened in the “taper tantrums” in the US in 2013?
- Will exceptional volatility be focused on the short or long-end of the yield curve, or both?

As the US financial markets are, by far, the biggest financial markets in the world, any upward trend in treasury yields will invariably impact and influence financial markets in other countries. Inflationary pressures and erosion of surplus economic capacity look much stronger in the US compared to those in the UK, which would suggest that Fed rate increases eventually needed to suppress inflation, are likely to be faster and stronger than Bank Rate increases in the UK. This is likely to put upward pressure on treasury yields which could then spill over into putting upward pressure on UK gilt yields.

The forecasts are also predicated on an assumption that there is no break-up of the Eurozone or EU within the forecasting period, despite the major challenges that are looming up, and that there are no major ructions in international relations, especially between the US and Russia, China / North Korea and Iran, which have a major impact on international trade and world GDP growth.

The balance of risks to medium to long term PWLB rates:-

- There is a balance of upside risks to forecasts for medium to long term PWLB rates.

A new era – a fundamental shift in central bank monetary policy

One of the key results of the pandemic has been a fundamental rethinking and shift in monetary policy by major central banks like the Fed, the Bank of England and the ECB, to tolerate a higher level of inflation than in the previous two decades when inflation was the prime target to bear down on so as to stop it going above a target rate. There is now also a greater emphasis on other targets for monetary policy than just inflation,

especially on 'achieving broad and inclusive "maximum" employment in its entirety' in the US, before consideration would be given to increasing rates.

- The Fed in America has gone furthest in adopting a monetary policy based on a clear goal of allowing the inflation target to be symmetrical, (rather than a ceiling to keep under), so that inflation averages out the dips down and surges above the target rate, over an unspecified period of time.
- The Bank of England has also amended its target for monetary policy so that inflation should be 'sustainably over 2%' before starting on raising Bank Rate and the ECB now has a similar policy.
- **For local authorities, this means that investment interest rates and very short term PWLB rates will not be rising as quickly or as high as in previous decades when the economy recovers from a downturn and the recovery eventually runs out of spare capacity to fuel continuing expansion.**
- Labour market liberalisation since the 1970s has helped to break the wage-price spirals that fuelled high levels of inflation and has now set inflation on a lower path which makes this shift in monetary policy practicable. In addition, recent changes in flexible employment practices, the rise of the gig economy and technological changes, will all help to lower inflationary pressures.
- Governments will also be concerned to see interest rates stay lower as every rise in central rates will add to the cost of vastly expanded levels of national debt; (in the UK this is £21bn for each 1% rise in rates). On the other hand, higher levels of inflation will help to erode the real value of total public debt.

Deposit and borrowing rates

- **Deposit returns** are expected to improve in 2022/23. However, while markets are pricing in a series of Bank Rate hikes, actual economic circumstances may see the MPC fall short of these elevated expectations.
- **Borrowing interest rates** fell to historically very low rates as a result of the COVID crisis and the quantitative easing operations of the Bank of England and still remain at historically low levels. The policy of avoiding new borrowing by running down spare cash balances has served local authorities well over the last few years.
- On 25.11.20, the Chancellor announced the conclusion to the review of margins over gilt yields for PWLB rates which had been increased by 100 bps in October 2019. The standard and certainty margins were reduced by 100 bps but a prohibition was introduced to deny access to borrowing from the PWLB for any local authority which had purchase of assets for yield in its three-year capital programme. The current margins over gilt yields are as follows: -
 - **PWLB Standard Rate** is gilt plus 100 basis points (G+100bps)
 - **PWLB Certainty Rate** is gilt plus 80 basis points (G+80bps)
 - **PWLB HRA Standard Rate** is gilt plus 100 basis points (G+100bps)
 - **PWLB HRA Certainty Rate** is gilt plus 80bps (G+80bps)
 - **Local Infrastructure Rate** is gilt plus 60bps (G+60bps)
- **Borrowing for capital expenditure.** Link Group's long-term (beyond 10 years), forecast for Bank Rate is 2.00%. As some PWLB certainty rates are currently below 2.00%, there remains value in considering long-term borrowing from the PWLB where appropriate. Temporary borrowing rates are likely, however, to remain near Bank Rate and may also prove attractive as part of a balanced debt portfolio. Other forward borrowing opportunities, which largely avoid a cost of carry, will continue to be explored.
- Given the continued uncertainty in the market there may be further opportunities for further long term borrowing to be undertaken in financial year 2021/22 and into early 2022/23 to fund the Council's £251 million medium term borrowing requirement as outlined in Table 3 of the covering report. Any

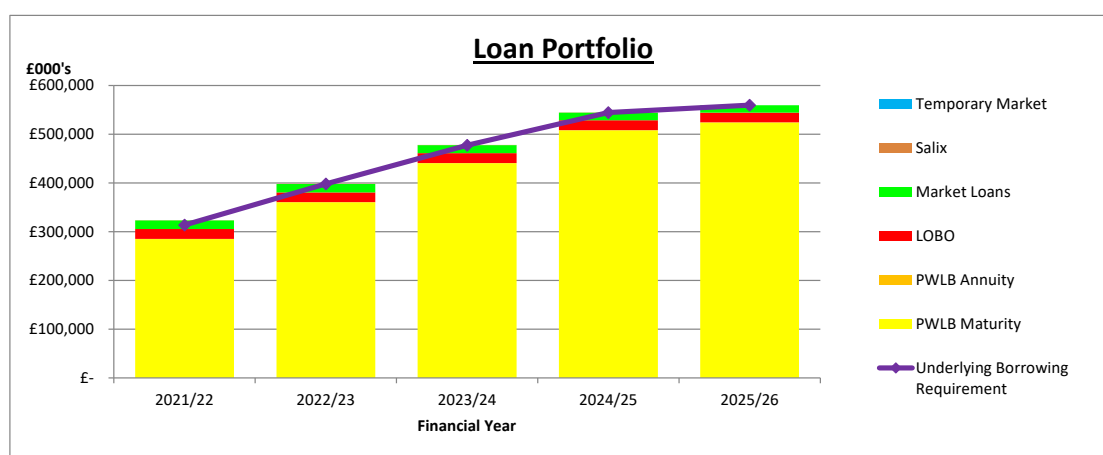
borrowing drawn would be supported by a business case which will appraise the anticipated savings in borrowing costs (from expected increases in rates later in the year / in forthcoming years) against the carrying cost associated with borrowing in advance of need.

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

3.4 Borrowing strategy

Borrowing is undertaken to finance the Council's approved Capital plans and to do so in the most cost effective way. As can be noted from Table 4 above the Council has a significant borrowing requirement across the current and forthcoming four financial years (2021/22 to 2025/26).

The Council's projected loan portfolio over the period 2021/22 to 2025/26 is shown in graphical format below.



The Council has fully funded its current, and part of its 2022/23, borrowing requirement in a prudent way which balances (a) de-risking the longer term borrowing requirement at historically low longer term borrowing rates; against (b) the current year and forthcoming financial year budget projections.

Long-term PWLB borrowing rates for both HRA and non-HRA purposes have been at historically low levels and significantly below historical averages, with an expected gradual upward trend in these levels across the remainder of financial year 2021/22 and into 2022/23.

The Bank of England's Monetary Policy Committee raised base rate from 0.10% to 0.25% at their meeting on 16 December 2021. There are further rises forecast to base rate in Quarter 4 of 2022 (to 0.50%) Quarter 1 of 2023 (to 0.75%), Quarter 1 of 2024 (to 1.00%) and finally, Quarter 1 of 2025, which would take the base rate to 1.25%.

With this in mind, utilisation of an element of temporary borrowing – which typically tracks close to base rate levels – within the Council's overall loan portfolio may continue to provide a cost-effective solution to the Council. The quantum of this will continue to be assessed against the backdrop of potential long term costs if the opportunity is missed to take PWLB or other market loans at historically low medium-long term rates, particularly given the projected gradual rise in PWLB rates.

The opportunity also continues to exist to consider further loans on a 'forward dealing' basis, and officers will continue to explore the viability of these loans as part of securing the long term borrowing required to meet the capital financing requirements.

Given the potential for uncertainty in the market to bring a dip in gilt yields and therefore PWLB rates, there may be further opportunities for further long term borrowing to be undertaken in financial year 2021/22 and into early 2022/23 to fund the Council's £224million remaining medium term borrowing requirement to 2025/26 as outlined in Table 4 above. Any further borrowing drawn would be supported by a business case which will appraise the anticipated savings in borrowing costs (from expected increases in rates later in the year / in forthcoming years) against the carrying cost associated with borrowing in advance of need.

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

Treasury management limits on activity

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

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

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

Upper Limits on Exposure to Fixed and Variable Interest Rates 2022/23			
Interest rate exposures			Upper Limit
Limits on fixed interest rates based on gross debt			100.00%
Limits on variable interest rates based on gross debt			30.00%
Limits on fixed interest rates based on investments			100.00%
Limits on variable interest rates based on investments			100.00%

Maturity Structure of Borrowing 2022/23		
Maturity structure of fixed interest rate borrowing 2022/23	Lower	Upper
Under 12 months	0.00%	50.00%
12 months to 2 years	0.00%	50.00%
2 years to 5 years	0.00%	50.00%
5 years to 10 years	0.00%	50.00%
10 years to 20 years	0.00%	50.00%
20 years to 30 years	0.00%	50.00%
30 years to 40 years	0.00%	50.00%
40 years to 50 years	0.00%	50.00%
50 years and above	0.00%	50.00%
Maturity structure of variable interest rate borrowing 2021/22	Lower	Upper
<i>Under 12 months</i>	0.00%	30.00%
<i>12 months to 2 years</i>	0.00%	30.00%
<i>2 years to 5 years</i>	0.00%	30.00%
<i>5 years to 10 years</i>	0.00%	30.00%
<i>10 years to 20 years</i>	0.00%	30.00%
<i>20 years to 30 years</i>	0.00%	30.00%
<i>30 years to 40 years</i>	0.00%	30.00%
<i>40 years to 50 years</i>	0.00%	30.00%
<i>50 years and above</i>	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

Rescheduling of current borrowing in our debt portfolio is unlikely to occur as there is still a very large difference between premature redemption rates and new borrowing rates, even though the general margin of PWLB rates over gilt yields was reduced by 100 bps in November 2020.

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

4 ANNUAL INVESTMENT STRATEGY

4.1 Investment policy

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

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

The Council's investment priorities will be security first, portfolio liquidity second and then yield, (return). The Council will aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity and with the Council's risk appetite.

The above regulations and guidance place a high priority on the management of risk. This authority has adopted a prudent approach to managing risk and defines its risk appetite by the following means: -

1. 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.
2. 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.
3. **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.
4. This authority has defined the list of **types of investment instruments** that are permitted investments authorised for use in appendix 5.2. Appendix 5.3 expands on the risks involved in each type of investment and the mitigating controls.
5. **Lending limits**, (maturity tenors), for each counterparty will be set through applying the matrix table in Section 4.2 (maturity durations).
6. Investments will only be placed with counterparties from countries with a specified minimum **sovereign rating**, (see paragraph 4.3).
7. Lending per **Country** and **Institution** will be set through the application of the criteria in Section 4.3 (amounts).
8. **Transaction limits** are set for each type of investment in appendix 5.2.
9. This authority will set a limit for the amount of its investments which are invested for **longer than 365 days**, (see paragraph 4.4).

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

11. All investments will be denominated in sterling.

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

4.2 Creditworthiness policy

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

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

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

Table 14: Recommended Maximum Durations for Investments	
Link Asset Services Colour Code	Maximum Suggested Duration for Investment
Yellow	6 years*
Dark Pink	6 years**
Light Pink	6 years**
Purple	2.5 years
Blue	1.25 years***
Orange	1.25 years
Red	7 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 Group, Treasury Solutions 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 Group, Treasury Solutions 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 Group, Treasury Solutions. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

Sole reliance will not be placed on the use of this external service. In addition this Council will also use market data and market information, information on sovereign support for banks and the credit ratings of that supporting government.

UK banks – ring fencing

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

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

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

4.3 Country and sector limits

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

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

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

4.4 Investment strategy

Current Deposits

As at 7 January 2022, the Council's deposits were as follows:-

Counterparty	Amount £000's	Security Long/Short Term Rating* (Colour)**	Liquidity	Yield	UK Local Authority Investment*** £000's
MMF Aberdeen	14,909	AAAmmf (Yellow)	Instant Access	0.05%	1,316,048
MMF Federated	14,909	AAAmmf (Yellow)	Instant Access	0.04%	1,035,348
MMF LGIM	8,102	AAAmmf (Yellow)	Instant Access	0.02%	129,103
RBS Call Account	2,325	A+/F1 (Blue)	Instant Access	0.01%	180,570
Svenska Handelsbanken AB Call Account	14,900	AA/F1+ (Orange)	Instant Access	0.05%	721,491
Santander	14,985	A+/F1 (Red)	180 day notice account	0.58%	648,018
Goldman Sachs International Bank	15,000	A+/F1 (Red)	Start: 17 Dec 2021 End: 17 Jun 2022	0.47%	1,095,653
Standard Chartered Bank	15,000	A+/F1 (Red)	Start: 17 Dec 2021 End: 17 Jun 2022	0.39%	640,018
National Bank of Canada	5,000	A+/F1 (Orange)	Start: 17 Dec 2021 End: 17 Jun 2022	0.32%	95,000
Wokingham Borough Council	15,000	Quasi-UK Government (AA- / Yellow)	Start: 25 Mar 2020 End: 24 Mar 2023	1.60%	3,315,722
Medway Council	15,000	Quasi-UK Government (AA- / Yellow)	Start: 30 Mar 2020 End: 30 Mar 2022	1.80%	
London Borough of Croydon	13,000	Quasi-UK Government (AA- / Yellow)	Start: 03 Apr 2020 End: 03 Oct 2022	1.85%	
Stoke on Trent City Council	2,000	Quasi-UK Government (AA- / Yellow)	Start: 06 Apr 2020 End: 06 Apr 2023	1.60%	
London Borough of Waltham Forest	15,000	Quasi-UK Government (AA- / Yellow)	Start: 06 Apr 2020 End: 06 Apr 2023	1.25%	
Total	165,130				9,176,971

* Credit Rating from Fitch

** Colour represents maximum recommended duration for investment per Link Group, Treasury Solutions, Treasury Solutions Credit Scoring methodology – see Appendix 2.

*** As at 31 October 2021

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

that could be invested for longer periods, the value to be obtained from longer term investments will be carefully assessed.

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

Investment returns expectations

The current forecast shown in paragraph 3.3, includes a forecast for a first increase in Bank Rate (from 0.25% to 0.50%) in May 2022, though it could come in February.

The suggested budgeted investment earnings rates for returns on investments placed for periods up to about three months during each financial year, (based on a first increase in Bank Rate in quarter 2 of 2022), are as follows.:

Average earnings in each year	
2022/23	0.50%
2023/24	0.75%
2024/25	1.00%
2025/26	1.25%
Long term later years	2.00%

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

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

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

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

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

4.5 Investment risk benchmarking

The Council will use an investment benchmark to assess the investment performance of its investment portfolio of 6 month SONIA compounded. The Council also participates in Investment Benchmarking groups with Link Group, Treasury Solutions whereby performance with other Benchmarking club members and the wider Scottish and UK Local Authority Investment benchmarking is compared.

4.6 End of year investment report

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

5 Appendices

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

5.1 APPENDIX: Economic Background

COVID-19 vaccines.

These were the game changer during 2021 which raised high hopes that life in the UK would be able to largely return to normal in the second half of the year. However, the bursting onto the scene of the Omicron mutation at the end of November, rendered the initial two doses of all vaccines largely ineffective in preventing infection. This has dashed such hopes and raises the spectre again that a fourth wave of the virus could overwhelm hospitals in early 2022. What we now know is that this mutation is very fast spreading with the potential for total case numbers to double every two to three days, although it possibly may not cause so much severe illness as previous mutations. Rather than go for full lockdowns which heavily damage the economy, the government strategy this time is focusing on getting as many people as possible to have a third (booster) vaccination after three months from the previous last injection, as a booster has been shown to restore a high percentage of immunity to Omicron to those who have had two vaccinations. There is now a race on between how quickly boosters can be given to limit the spread of Omicron, and how quickly will hospitals fill up and potentially be unable to cope. In the meantime, workers have been requested to work from home and restrictions have been placed on large indoor gatherings and hospitality venues. With the household saving rate having been exceptionally high since the first lockdown in March 2020, there is plenty of pent-up demand and purchasing power stored up for services in sectors like restaurants, travel, tourism and hotels which had been hit hard during 2021, but could now be hit hard again by either, or both, of government restrictions and/or consumer reluctance to leave home. Growth will also be lower due to people being ill and not working, similar to the pingdemic in July. The economy, therefore, faces significant headwinds although some sectors have learned how to cope well with Covid. However, the biggest impact on growth would come from another lockdown if that happened. The big question still remains as to whether any further mutations of this virus could develop which render all current vaccines ineffective, as opposed to how quickly vaccines can be modified to deal with them and enhanced testing programmes be implemented to contain their spread until tweaked vaccines become widely available.

A SUMMARY OVERVIEW OF THE FUTURE PATH OF BANK RATE

- In December, the Bank of England became the first major western central bank to put interest rates up in this upswing in the current business cycle in western economies as recovery progresses from the Covid recession of 2020.
- The next increase in Bank Rate could be in February or May, dependent on how severe an impact there is from Omicron.
- If there are lockdowns in January, this could pose a barrier for the MPC to putting Bank Rate up again as early as 3rd February.
- With inflation expected to peak at around 6% in April, the MPC may want to be seen to be active in taking action to counter inflation on 5th May, the release date for its Quarterly Monetary Policy Report.
- The December 2021 MPC meeting was more concerned with combating inflation over the medium term than supporting economic growth in the short term.
- Bank Rate increases beyond May are difficult to forecast as inflation is likely to drop sharply in the second half of 2022.
- However, the MPC will want to normalise Bank Rate over the next three years so that it has its main monetary policy tool ready to use in time for the next down-turn; all rates under 2% are providing stimulus to economic growth.
- We have put year end 0.25% increases into Q1 of each financial year from 2023 to recognise this upward bias in Bank Rate - but the actual timing in each year is difficult to predict.

- Covid remains a major potential downside threat in all three years as we ARE likely to get further mutations.
- How quickly can science come up with a mutation proof vaccine, or other treatment, – and for them to be widely administered around the world?
- Purchases of gilts under QE ended in December. Note that when Bank Rate reaches 0.50%, the MPC has said it will start running down its stock of QE.

MPC MEETING 16TH DECEMBER 2021

- The Monetary Policy Committee (MPC) voted 8-1 to raise Bank Rate by 0.15% from 0.10% to 0.25% and unanimously decided to make no changes to its programme of quantitative easing purchases due to finish in December 2021 at a total of £895bn.
- The MPC disappointed financial markets by not raising Bank Rate at its November meeting. Until Omicron burst on the scene, most forecasters, therefore, viewed a Bank Rate increase as being near certain at this December meeting due to the way that inflationary pressures have been comprehensively building in both producer and consumer prices, and in wage rates. However, at the November meeting, the MPC decided it wanted to have assurance that the labour market would get over the end of the furlough scheme on 30th September without unemployment increasing sharply; their decision was, therefore, to wait until statistics were available to show how the economy had fared at this time.
- **On 10th December we learnt of the disappointing 0.1% m/m rise in GDP** in October which suggested that economic growth had already slowed to a crawl even before the Omicron variant was discovered in late November. Early evidence suggests growth in November might have been marginally better. Nonetheless, at such low rates of growth, the government's "Plan B" COVID-19 restrictions could cause the economy to contract in December.
- **On 14th December, the labour market statistics** for the three months to October and the single month of October were released. The fallout after the furlough scheme was smaller and shorter than the Bank of England had feared. The single-month data were more informative and showed that LFS employment fell by 240,000, unemployment increased by 75,000 and the unemployment rate rose from 3.9% in September to 4.2%. However, the weekly data suggested this didn't last long as unemployment was falling again by the end of October. What's more, the 49,700 fall in the claimant count and the 257,000 rise in the PAYE measure of company payrolls suggests that the labour market strengthened again in November. The other side of the coin was a further rise in the number of vacancies from 1.182m to a record 1.219m in the three months to November which suggests that the supply of labour is struggling to keep up with demand, although the single-month figure for November fell for the first time since February, from 1.307m to 1.227m.
- These figures by themselves, would probably have been enough to give the MPC the assurance that it could press ahead to raise Bank Rate at this December meeting. However, the advent of Omicron potentially threw a spanner into the works as it poses a major headwind to the economy which, of itself, will help to cool the economy. The financial markets, therefore, swung round to expecting no change in Bank Rate.
- **On 15th December we had the CPI inflation** figure for November which spiked up further from 4.2% to 5.1%, confirming again how inflationary pressures have been building sharply. However, Omicron also caused a sharp fall in world oil and other commodity prices; (gas and electricity inflation has generally accounted on average for about 60% of the increase in inflation in advanced western economies).
- **Other elements of inflation are also transitory** e.g., prices of goods being forced up by supply shortages, and shortages of shipping containers due to

ports being clogged have caused huge increases in shipping costs. But these issues are likely to clear during 2022, and then prices will subside back to more normal levels. Gas prices and electricity prices will also fall back once winter is passed and demand for these falls away.

- Although it is possible that the Government could step in with some **fiscal support for the economy**, the huge cost of such support to date is likely to pose a barrier to incurring further major expenditure unless it was very limited and targeted on narrow sectors like hospitality. The Government may well, therefore, effectively leave it to the MPC, and to monetary policy, to support economic growth – but at a time when the threat posed by rising inflation is near to peaking!
- This is the adverse set of factors against which the MPC had to decide on Bank Rate. For the second month in a row, the MPC blind-sided financial markets, this time with a **surprise increase in Bank Rate from 0.10% to 0.25%**. What's more, the hawkish tone of comments indicated that the MPC is now concerned that inflationary pressures are indeed building and need concerted action by the MPC to counter. This indicates that there will be more increases to come with financial markets predicting 1% by the end of 2022. The 8-1 vote to raise the rate shows that there is firm agreement that inflation now poses a threat, especially after the CPI figure hit a 10-year high this week. The MPC commented that "there has been significant upside news" and that "there were some signs of greater persistence in domestic costs and price pressures".
- On the other hand, it did also comment that "**the Omicron variant is likely to weigh on near-term activity**". But it stressed that at the November meeting it had said it would raise rates if the economy evolved as it expected and that now "these conditions had been met". It also appeared more worried about the possible boost to inflation from Omicron itself. It said that "the current position of the global and UK economies was materially different compared with prior to the onset of the pandemic, including elevated levels of consumer price inflation". It also noted the possibility that renewed social distancing would boost demand for goods again, (as demand for services would fall), meaning "global price pressures might persist for longer". (Recent news is that the largest port in the world in China has come down with an Omicron outbreak which is not only affecting the port but also factories in the region.)
- On top of that, there were no references this month to inflation being expected to be below the **2% target in two years' time**, which at November's meeting the MPC referenced to suggest the markets had gone too far in expecting interest rates to rise to over 1.00% by the end of the year.
- These comments indicate that there has been a material reappraisal by the MPC of the inflationary pressures since their last meeting and the Bank also increased its forecast for inflation to peak at 6% next April, rather than at 5% as of a month ago. However, as the Bank retained its guidance that only a "**modest tightening**" in policy will be required, it cannot be thinking that it will need to increase interest rates that much more. A typical policy tightening cycle has usually involved rates rising by 0.25% four times in a year. "Modest" seems slower than that. As such, the Bank could be thinking about raising interest rates two or three times next year to 0.75% or 1.00%.
- In as much as a considerable part of the inflationary pressures at the current time are indeed **transitory**, and will naturally subside, and since economic growth is likely to be weak over the next few months, this would appear to indicate that this tightening cycle is likely to be comparatively short.
- As for the timing of the next increase in Bank Rate, the MPC dropped the comment from November's statement that Bank Rate would be raised "in the coming months". That may imply another rise is unlikely at the next meeting in February and that May is more likely. However, much could depend on how adversely, or not, the economy is affected by Omicron in the run up to the next meeting on 3rd February. Once 0.50% is reached, the Bank would act to

start shrinking its stock of QE, (gilts purchased by the Bank would not be replaced when they mature).

- **The MPC's forward guidance on its intended monetary policy** on raising Bank Rate versus selling (quantitative easing) holdings of bonds is as follows:-
 - Raising Bank Rate as "the active instrument in most circumstances".
 - Raising Bank Rate to 0.50% before starting on reducing its holdings.
 - Once Bank Rate is at 0.50% it would stop reinvesting maturing gilts.
 - Once Bank Rate had risen to at least 1%, it would start selling its holdings.

US.

- Shortages of goods and intermediate goods like semi-conductors, have been fuelling increases in prices and reducing economic growth potential. In November, **CPI inflation hit a near 40-year record level of 6.8%** but with energy prices then falling sharply, this is probably the peak. The biggest problem for the Fed is the mounting evidence of a strong pick-up in cyclical price pressures e.g., in rent which has hit a decades high.
- **Shortages of labour** have also been driving up wage rates sharply; this also poses a considerable threat to feeding back into producer prices and then into consumer prices inflation. It now also appears that there has been a sustained drop in the labour force which suggests the pandemic has had a longer-term scarring effect in reducing potential GDP. Economic growth may therefore be reduced to between 2 and 3% in 2022 and 2023 while core inflation is likely to remain elevated at around 3% in both years instead of declining back to the Fed's 2% central target.
- Inflation hitting 6.8% and the feed through into second round effects, meant that it was near certain that the **Fed's meeting of 15th December** would take aggressive action against inflation. Accordingly, the rate of tapering of monthly \$120bn QE purchases announced at its November 3rd meeting, was doubled so that all purchases would now finish in February 2022. In addition, Fed officials had started discussions on running down the stock of QE held by the Fed. Fed officials also expected three rate rises in 2022 of 0.25% from near zero currently, followed by three in 2023 and two in 2024, taking rates back above 2% to a neutral level for monetary policy. The first increase could come as soon as March 2022 as the chairman of the Fed stated his view that the economy had made rapid progress to achieving the other goal of the Fed – "maximum employment". The Fed forecast that inflation would fall from an average of 5.3% in 2021 to 2.6% in 2023, still above its target of 2% and both figures significantly up from previous forecasts. What was also significant was that this month the Fed dropped its description of the current level of inflation as being "transitory" and instead referred to "elevated levels" of inflation: the statement also dropped most of the language around the flexible average inflation target, with inflation now described as having exceeded 2 percent "for some time". It did not see Omicron as being a major impediment to the need to take action now to curtail the level of inflationary pressures that have built up, although Fed officials did note that it has the potential to exacerbate supply chain problems and add to price pressures.

See also comments in paragraph 3.3 under PWLB rates and gilt yields.

EU.

- The slow roll out of vaccines initially delayed economic recovery in early 2021 but the vaccination rate then picked up sharply. After a contraction of -0.3% in Q1, Q2 came in with strong growth of 2%. With Q3 at 2.2%, the EU

recovery was then within 0.5% of its pre Covid size. However, the arrival of Omicron is now a major headwind to growth in quarter 4 and the expected downturn into weak growth could well turn negative, with the outlook for the first two months of 2022 expected to continue to be very weak.

- **November's inflation figures** breakdown shows that the increase in price pressures is not just due to high energy costs and global demand-supply imbalances for durable goods as services inflation also rose. Headline inflation reached 4.9% in November, with over half of that due to energy. However, oil and gas prices are expected to fall after the winter and so energy inflation is expected to plummet in 2022. Core goods inflation rose to 2.4% in November, its second highest ever level, and is likely to remain high for some time as it will take a long time for the inflationary impact of global imbalances in the demand and supply of durable goods to disappear. Price pressures also increased in the services sector, but wage growth remains subdued and there are no signs of a trend of faster wage growth which might lead to persistently higher services inflation - which would get the ECB concerned. The upshot is that the euro-zone is set for a prolonged period of inflation being above the ECB's target of 2% and it is likely to average 3% in 2022, in line with the ECB's latest projection.
- **ECB tapering.** The ECB has joined with the Fed by also announcing at its meeting on 16th December that it will be reducing its QE purchases - by half from October 2022, i.e., it will still be providing significant stimulus via QE purchases for over half of next year. However, as inflation will fall back sharply during 2022, it is likely that it will leave its central rate below zero, (currently -0.50%), over the next two years. The main struggle that the ECB has had in recent years is that inflation has been doggedly anaemic in sticking below the ECB's target rate despite all its major programmes of monetary easing by cutting rates into negative territory and providing QE support.
- The ECB will now also need to consider the impact of **Omicron** on the economy, and it stated at its December meeting that it is prepared to provide further QE support if the pandemic causes bond yield spreads of peripheral countries, (compared to the yields of northern EU countries), to rise. However, that is the only reason it will support peripheral yields, so this support is limited in its scope.
- The EU has entered into a **period of political uncertainty** where a new German government formed of a coalition of three parties with Olaf Scholz replacing Angela Merkel as Chancellor in December 2021, will need to find its feet both within the EU and in the three parties successfully working together. In France there is a presidential election coming up in April 2022 followed by the legislative election in June. In addition, Italy needs to elect a new president in January with Prime Minister Draghi being a favourite due to having suitable gravitas for this post. However, if he switched office, there is a significant risk that the current government coalition could collapse. That could then cause differentials between Italian and German bonds to widen when 2022 will also see a gradual running down of ECB support for the bonds of weaker countries within the EU. These political uncertainties could have repercussions on economies and on Brexit issues.

CHINA.

- After a concerted effort to get on top of the virus outbreak in Q1 2020, economic recovery was strong in the rest of **2020**; this enabled China to recover all the initial contraction. During 2020, policy makers both quashed the virus and implemented a programme of monetary and fiscal support that was particularly effective at stimulating short-term growth. At the same time, China's economy benefited from the shift towards online spending by consumers in developed markets. These factors helped to explain its

comparative outperformance compared to western economies during 2020 and earlier in 2021.

- However, the pace of economic growth has now fallen back in **2021** after this initial surge of recovery from the pandemic and looks likely to be particularly weak in 2022. China has been struggling to contain the spread of the Delta variant through using sharp local lockdowns - which depress economic growth. Chinese consumers are also being very wary about leaving home and so spending money on services. However, with Omicron having now spread to China, and being much more easily transmissible, this strategy of sharp local lockdowns to stop the virus may not prove so successful in future. In addition, the current pace of providing boosters at 100 billion per month will leave much of the 1.4 billion population exposed to Omicron, and any further mutations, for a considerable time.
- The **People's Bank of China** made a start in December 2021 on cutting its key interest rate marginally so as to stimulate economic growth. However, after credit has already expanded by around 25% in just the last two years, it will probably leave the heavy lifting in supporting growth to fiscal stimulus by central and local government.
- Supply shortages, especially of coal for power generation, were causing widespread power cuts to industry during the second half of 2021 and so a sharp disruptive impact on some sectors of the economy. In addition, recent regulatory actions motivated by a political agenda to channel activities into officially approved directions, are also likely to reduce the dynamism and long-term growth of the Chinese economy.

JAPAN.

- 2021 has been a patchy year in combating Covid. However, recent business surveys indicate that the economy has been rebounding rapidly in 2021 once the bulk of the population had been double vaccinated and new virus cases had plunged. However, Omicron could reverse this initial success in combating Covid.
- The Bank of Japan is continuing its **very loose monetary policy** but with little prospect of getting inflation back above 1% towards its target of 2%, any time soon: indeed, inflation was actually negative in July. New Prime Minister Kishida, having won the November general election, brought in a supplementary budget to boost growth, but it is unlikely to have a major effect.

WORLD GROWTH.

- World growth was in recession in 2020 but recovered during 2021 until starting to lose momentum in the second half of the year, though overall growth for the year is expected to be about 6% and to be around 4-5% in 2022. Inflation has been rising due to increases in gas and electricity prices, shipping costs and supply shortages, although these should subside during 2022. While headline inflation will fall sharply, core inflation will probably not fall as quickly as central bankers would hope. It is likely that we are heading into a period where there will be **a reversal of world globalisation** and a decoupling of western countries from dependence on China to supply products, and vice versa. This is likely to reduce world growth rates from those in prior decades.

SUPPLY SHORTAGES.

- The pandemic and extreme weather events, followed by a major surge in demand after lockdowns ended, have been highly disruptive of extended worldwide supply chains. Major queues of ships unable to unload their goods

at ports in New York, California and China built up rapidly during quarters 2 and 3 of 2021 but then halved during quarter 4. Such issues have led to a misdistribution of shipping containers around the world and have contributed to a huge increase in the cost of shipping. Combined with a shortage of semi-conductors, these issues have had a disruptive impact on production in many countries. The latest additional disruption has been a shortage of coal in China leading to power cuts focused primarily on producers (rather than consumers), i.e., this will further aggravate shortages in meeting demand for goods. Many western countries are also hitting up against a difficulty in filling job vacancies. It is expected that these issues will be gradually sorted out, but they are currently contributing to a spike upwards in inflation and shortages of materials and goods available to purchase.

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

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

Treasury risks

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

1. **Credit and counter-party risk:** this is the risk of failure by a counterparty (bank or building society) to meet its contractual obligations to the organisation particularly as a result of the counterparty's diminished creditworthiness, and the resulting detrimental effect on the organisation's capital or current (revenue) resources. There are no counterparties where this risk is zero although AAA rated organisations have the highest, relative, level of creditworthiness.
2. **Liquidity risk:** this is the risk that cash will not be available when it is needed. While it could be said that all counterparties are subject to at least a very small level of liquidity risk as credit risk can never be zero, in this document, liquidity risk has been treated as whether or not instant access to cash can be obtained from each form of investment instrument. However, it has to be pointed out that while some forms of investment e.g. gilts, CDs, corporate bonds can usually be sold immediately if the need arises, there are two caveats: - a. cash may not be available until a settlement date up to three days after the sale b. there is an implied assumption that markets will not freeze up and so the instrument in question will find a ready buyer. The column in tables 1.1-1.4 headed as 'market risk' will show each investment instrument as being instant access, sale T+3 = transaction date plus 3 business days before you get cash, or term i.e. money is locked in until an agreed maturity date.
3. **Market risk:** this is the risk that, through adverse market fluctuations in the value of the principal sums an organisation borrows and invests, its stated treasury management policies and objectives are compromised, against which effects it has failed to protect itself adequately. However, some cash rich local authorities may positively want exposure to market risk e.g. those investing in investment instruments with a view to obtaining a long term increase in value.
4. **Interest rate risk:** this is the risk that fluctuations in the levels of interest rates create an unexpected or unbudgeted burden on the organisation's finances, against which the organisation has failed to protect itself adequately. This authority has set limits for its fixed and variable rate exposure in its Treasury Indicators in this report (see Section 3.4).
5. **Legal and regulatory risk:** this is the risk that the organisation itself, or an organisation with which it is dealing in its treasury management activities, fails to act in accordance with its legal powers or regulatory requirements, and that the organisation suffers losses accordingly.

Controls on treasury risks

1. **Credit and counter-party risk:** this authority has set minimum credit criteria to determine which counterparties and countries are of sufficiently high creditworthiness to be considered for investment purposes. See Sections 4.2 and 4.3.
2. **Liquidity risk:** this authority has a cash flow forecasting model to enable it to determine how long investments can be made for and how much can be invested.
3. **Market risk:** this authority does not purchase investment instruments which are subject to market risk in terms of fluctuation in their value.
4. **Interest rate risk:** this authority manages this risk by having a view of the future course of interest rates and then formulating a treasury management strategy accordingly which aims to maximise investment earnings consistent with control of risk or alternatively, seeks to minimise expenditure on interest costs on borrowing. See Section 4.4.
5. **Legal and regulatory risk:** this authority will not undertake any form of investing until it has ensured that it has all necessary powers and also complied with all regulations.

Unlimited investments

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

1. **Debt Management Agency Deposit Facility.** This is considered to be the lowest risk form of investment available to local authorities as it is operated by the Debt Management Office which is part of H.M. Treasury i.e. the UK Government's sovereign rating stands behind the DMADF. It is also a deposit account and avoids the complications of buying and holding Government issued treasury bills or gilts.
2. **High credit worthiness banks and building societies.** See paragraph 4.2 for an explanation of this authority's definition of high credit worthiness. While an unlimited amount of the investment portfolio may be put into banks and building societies with high credit worthiness, the authority will ensure diversification of its portfolio ensuring that no more than £15 million can be placed with any one institution or group at any one time, other than the Bank of Scotland or Royal Bank of Scotland where the limit is £30 million.

Objectives of each type of investment instrument

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

1. DEPOSITS

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

- a) **Debt Management Agency Deposit Facility.** This offers the lowest risk form of investment available to local authorities as it is effectively an investment placed with the Government. It is also easy to use as it is a deposit account and avoids the complications of buying and holding Government issued treasury bills or gilts. As it is low risk it also earns low rates of interest. However, it is very useful for authorities whose overriding priority is the avoidance of risk. The longest period for a term deposit with the DMADF is 6 months.
- b) **Term Deposits – Local Authorities.** They are quasi-Government bodies with low counterparty and value risk. Typical deposit terms vary from 1 month to 2 years, with longer term deposits offering an opportunity to increase investment returns by locking in high rates ahead of an expected fall in the level of interest rates. At other times, longer term rates can offer good value when the markets incorrectly assess the speed and timing of interest rate increases. This form of investing therefore, offers a lot of flexibility and typically higher earnings than the DMADF. Where it is restricted is that once a longer term investment is made, that cash is locked in until the maturity date other than with agreement of the counterparty, at which point penalties would typically apply.
- c) **Call accounts with high credit worthiness banks and building societies.** See Section 4.2 for an explanation of this authority's definition of high credit worthiness. These typically offer a much higher rate of return than the DMADF and now that measures have been put in place to avoid over reliance on credit ratings, the authority feels much more confident that the residual risks around using such banks and building societies are at a low, reasonable and acceptable level. There is instant access to recalling cash deposited (or short-dated notice e.g. 15-30 days). This generally means accepting a lower rate of interest than that which could be earned from the same institution by making a term deposit (see 1d below). However, there are a number of call accounts which at the time of writing, offer rates 2 – 3 times more than term deposits with the DMADF. Some use of call accounts is highly desirable to ensure that the authority has ready access to cash when needed to pay bills.
- d) **Term deposits with high credit worthiness banks and building societies.** The objectives are as for 1c. These offer a much higher rate of return than the DMADF and deposits made with other Local Authorities (dependent upon term) and, similar to 1c, now that measures have been put in place to avoid over reliance on credit ratings, the authority feels much more confident that the residual risks around using such banks and building societies are at a low, reasonable and acceptable level. This is the most widely used form of investing used by local authorities. The authority will ensure diversification of its portfolio of deposits ensuring that no more than £15 million is invested with any (non-nationalised) UK counterparty, and no more than £15 million is invested with any other non-UK counterparty, group or country. In addition, longer term deposits offer an opportunity to increase investment returns by locking in high rates ahead of an expected fall in the level of interest rates. At other times, longer term rates can offer good value when the markets incorrectly assess the speed and timing of interest rate increases. This form of investing therefore, offers a lot of flexibility and higher earnings than the DMADF. Where it is restricted is that once a longer term investment is made, that cash is locked in until the maturity date.
- e) **Fixed term deposits with variable rate and variable maturities (structured deposits).** This encompasses ALL types of structured deposits. There has been considerable change in the types of structured deposits brought to the market over the last few years, some of which are already no longer available. In view of the fluidity of

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

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

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

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

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

- a. **Government liquidity funds.** These are the same as money market funds (see below) but only invest in government debt issuance with highly rated governments. Due to the higher quality of underlying investments, they offer a lower rate of return than MMFs. However, their net return is typically on a par with the DMADF, but with instant access.
- b. **Money Market Funds (MMFs).** By definition, MMFs are AAA rated and are widely diversified, using many forms of money market securities including types which this authority does not currently have the expertise or capabilities to hold directly. However, due to the high level of expertise of the fund managers and the huge amounts of money invested in MMFs, and the fact that the weighted average maturity (WAM) cannot exceed 60 days, MMFs offer a combination of high security, instant access to funds, high diversification and good rates of return compared to equivalent instant access facilities. They are particularly advantageous in falling interest rate environments as their 60 day WAM means they have locked in investments earning higher rates of interest than are currently available in the market. MMFs also help an authority to diversify its own portfolio as e.g. a £2m investment placed directly with HSBC is a 100% risk exposure to HSBC whereas £2m invested in a MMF may end up with say £10,000 being invested with HSBC through the MMF. For authorities particularly concerned with risk exposure to banks, MMFs offer an effective way of minimising risk exposure while still getting much better rates of return than available through the DMADF.
- c. **Ultra Short Dated Bond Funds .** These funds are similar to MMFs, can still be AAA rated but have Variable Net Asset Values (VNAV) as opposed to a traditional MMF which has a Constant Net Asset Value (CNAV). They aim to achieve a higher yield and to do this either take more credit risk or invest out for longer periods of time, which means they are more volatile. These funds can have WAM's and Weighted Average Life (WAL's) of 90 – 365 days or even longer. Their primary objective is yield and capital preservation is second. They therefore are a higher risk than MMFs and correspondingly have the potential to earn higher returns than MMFs.
- d. **Gilt funds.** These are funds which invest only in U.K. Government gilts. They offer a lower rate of return than bond funds but are highly rated both as a fund and through investing only in highly rated government securities. They offer a higher rate of return than investing in the DMADF but they do have an exposure to movements in market prices of assets held.
- e. **Bond funds.** These can invest in both government and corporate bonds. This therefore entails a higher level of risk exposure than gilt funds and the aim is to achieve a higher rate of return than normally available from gilt funds by trading in non-government bonds.

4. SECURITIES ISSUED OR GUARANTEED BY GOVERNMENTS

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

- a. **Treasury bills.** These are short term bills (up to 12 months, although none have ever been issued for this maturity) issued by the Government and so are backed by the sovereign rating of the UK. The yield is higher than the rate of interest paid by the DMADF and another advantage compared to a time deposit in the DMADF is that they can be sold if there is a need for access to cash at any point in time. However, there is a spread between purchase and sale prices so early sales could incur a net cost during the period of ownership.
- b. **Gilts.** These are longer term debt issuance by the UK Government and are backed by the sovereign rating of the UK. The yield is higher than the rate of interest paid by the DMADF and another advantage compared to a time deposit in the DMADF is that they can be sold if there is a need for access to cash at any point in time. However, there is a spread between purchase and sale prices so early sales may incur a net cost. Market movements that occur between purchase and sale may also have an adverse impact on proceeds. The advantage over Treasury bills is that they generally offer higher yields the longer it is to maturity (for most periods) if the yield curve is positive.
- c. **Bond issuance issued by a financial institution which is explicitly guaranteed by the UK Government** e.g. National Rail. This is similar to a gilt due to the explicit Government guarantee.
- d. **Sovereign bond issues (other than the UK govt) denominated in Sterling.** As for gilts but issued by other nations. Use limited to issues of nations with at least the same sovereign rating as for the UK.
- e. **Bonds issued by Multi Lateral Development Banks (MLDBs).** These are similar to c. and e. above but are issued by MLDBs which are typically guaranteed by a group of sovereign states e.g. European Bank for Reconstruction and Development.

5. SECURITIES ISSUED BY CORPORATE ORGANISATIONS

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

- a. **Certificates of deposit (CDs).** These are shorter term securities issued by deposit taking institutions (mainly financial institutions). They are negotiable instruments, so can be sold ahead of maturity and also purchased after they have been issued. However, that liquidity can come at a price, where the yield could be marginally less than placing a deposit with the same bank as the issuing bank.
- b. **Commercial paper.** This is similar to CDs but is issued by commercial organisations or other entities. Maturity periods are up to 365 days but commonly 90 days.

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

6. OTHER

- a. **Local Authority Mortgage Scheme.** Authorities who are participating in the Local Authority Mortgage Guarantee Scheme (LAMS) may be required to place a deposit with the mortgage provider(s) up to the full value of the guarantee. The deposit will be in place for the term of the guarantee i.e. 5 years (with the possibility of a further 2 year extension if the account is 90+ days in arrears at the end of the initial 5 years) - and may have conditions / structures attached. The mortgage provider will not hold a legal charge over the deposit.
- b. **Loans to third parties** – This would involve the Council borrowing from the PWLB/markets and onward lending to Registered Social Landlords to enable them to access lower cost loans and kickstart developments of affordable mid-market homes. The risk associated with such an investment would be mitigated by an assessment of the counterparty in advance of any loan being granted and through the application of a premium on the loan rate. Interest would be paid by the RSL over the term of the loan, with repayment of principal upon the earlier of 10/20 years or at the point of house sales. The Council will also request that a standard security is taken over the property which would allow the Council to require the sale of the homes to another landlord, providing greater risk mitigation.
- c. **Subordinated Debt Subscription to the SPV set up to deliver the Newbattle Centre project** – this involved the Council subscribing £332,806 of subordinated debt to the SPV that was set up to deliver the Newbattle Centre project (2 year construction and 25 year operational contract length). The length of the investment is 25 years with the subscription made at operation commencement of the contract. The repayment profile will comprise 81% of the principal remaining invested until the final two years of the contract. The risk associated with this type of investment will be mitigated through an annual assessment as a minimum to review the holding of such debt, and whether the exposure to risk arising from the investment has changed over the period.
- d. **ESCO:** Midlothian Energy Limited (MEL) Joint Venture between Midlothian Council and Vattenfall to deliver energy supply to Shawfair using heat supplied from the Millerhill Energy from Waste plant and related projects.

Table 1: Permitted Investments**1.1 Deposits**

Investment Category	Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period	Max Transaction Value
Debt Management Agency Deposit Facility	UK Government	Term	No	100%	6 months	£30m
Term deposits – local authorities	Quasi-UK Government	Term	No	100%	5 years	£15m
Call accounts – banks and building societies	Green	Instant	No	100%	1 day	£15m
Term deposits / Notice Accounts – banks and building societies	Yellow Purple Blue Orange Red Green No Colour	Term	No	100%	Up to 6 yrs Up to 2.5 yrs Up to 1.25 yrs Up to 1.25 yrs Up to 7 mths Up to 120 days Not for use	£15m
Fixed term deposits with variable rate and variable maturities: - Structured deposits	Yellow Purple Blue Orange Red Green No Colour	Term	No	100%	Up to 6 yrs Up to 2.5 yrs Up to 1.25 yrs Up to 1.25 yrs Up to 7 mths Up to 120 days Not for use	£15m

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

Investment Category	Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period	Max Transaction Value
UK nationalised banks – Call accounts	Blue	Instant	No	100%	1 day	£30m
UK nationalised banks – Term Deposits / Notice Accounts	Blue	Term	No	100%	2 years	£30m
UK nationalised banks – Fixed term deposits with variable rate and variable maturities: - Structured deposits	Blue	Term	No	100%	2 years	£30m
Non-UK (high sovereign rated country) nationalised banks – Call accounts	Green	Instant	No	100%	1 day	£15m
Non-UK (high sovereign rated country) nationalised banks:- Term Deposits / Notice Accounts	Yellow Purple Blue Orange Red Green No Colour	Term	No	100%	Up to 6 yrs Up to 2.5 yrs Up to 1.25 yrs Up to 1.25 yrs Up to 7 mths Up to 120 days Not for use	£15m
Non-UK (high sovereign rated country) nationalised banks:- Fixed term deposits with variable rate and variable maturities: - Structured deposits	Yellow Purple Blue Orange Red Green No Colour	Term	No	100%	Up to 6 yrs Up to 2.5 yrs Up to 1.25 yrs Up to 1.25 yrs Up to 7 mths Up to 120 days Not for use	£15m

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

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

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

1.4 Securities issued or guaranteed by governments

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

1.5 Securities issued by corporate organisations

Investment Category	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period	Max Transaction Value
Certificates of deposit issued by banks and building societies	Yellow Purple Blue Orange Red Green No Colour	Sale T+1	Yes	100%	Up to 6 yrs Up to 2.5 yrs Up to 1.25 yrs Up to 1.25 yrs Up to 7 mths Up to 120 days Not for use	£15m
Commercial paper other	Yellow Purple Blue Orange Red Green No Colour	Sale T+0	Yes	100%	Up to 6 yrs Up to 2.5 yrs Up to 1.25 yrs Up to 1.25 yrs Up to 7 mths Up to 120 days Not for use	£15m
Floating rate notes	Yellow Purple Blue Orange Red Green No Colour	Sale T+2	Yes	100%	Up to 6 yrs Up to 2.5 yrs Up to 1.25 yrs Up to 1.25 yrs Up to 7 mths Up to 120 days Not for use	£15m
Corporate Bonds other	Yellow Purple Blue Orange Red Green No Colour	Sale T+2	Yes	100%	Up to 6 yrs Up to 2.5 yrs Up to 1.25 yrs Up to 1.25 yrs Up to 7 mths Up to 120 days Not for use	£15m

1.6 Other

Investment Category	Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period
Local authority mortgage guarantee scheme.	Blue	Term	No	50%	5 years
Loans to Third Parties	n/a	Term	No	£25m	20 years
Subordinated Debt Subscription to Newbattle Centre SPV	n/a	Term	No	£0.326m	22 years
ESCO	n/a	Term	No	£10.2m	n/a

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

Midlothian Council Permitted Investments, Associated Controls and Limits

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

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits
e. Call account deposit accounts with financial institutions (banks and building societies) (Low risk depending on credit rating)	These tend to be low risk investments, but will exhibit higher risks than categories (a), (b) and (c) above. Whilst there is no risk to value with these types of investments, liquidity is high and investments can be returned at short notice.	<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 Group, Treasury Solutions 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 Group, Treasury Solutions 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 Group, Treasury Solutions overlaid. On day to day investment dealing, this criteria will be further strengthened by the use of additional market intelligence.	As shown in Appendix 5.2.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits
j. Corporate bonds (Medium to high risk depending on period & credit rating)	These are marketable securities issued by financial and corporate institutions. Counterparty risk will vary and there is risk to value of capital loss arising from selling ahead of maturity if combined with an adverse movement in interest rates. Liquidity risk will be low.	<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. 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.</p> <p>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.

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

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

5.4 APPENDIX: Approved countries for investments

Based on the lowest available rating as at 13.01.2022

AAA

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

AA+

- Canada
- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)
- France

AA-

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

5.5 APPENDIX: Treasury management scheme of delegation

(i) Full Council

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

(iii) Audit Committee

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

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

The S95 (responsible) officer

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

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

Internal Audit Work to December 2021

Report by Chief Internal Auditor

Report for Decision

1 Recommendations

The Audit Committee is asked to:

- a) Consider the Executive Summaries of the final Internal Audit assurance reports issued;
- b) Note the Internal Audit Assurance Work in Progress and Internal Audit and Other Work carried out; and
- c) Acknowledge the assurance provided on internal controls and governance arrangements in place for the areas covered by this Internal Audit work.

2 Purpose of Report/Executive Summary

The purpose of this report is to provide members of the Audit Committee with details of the recent work carried out by Internal Audit and the findings and recommended audit actions agreed by Management to improve internal controls and governance arrangements.

The Internal Audit Annual Plan 2021/22 was approved by the Audit Committee on 9 March 2021. Internal Audit has carried out work associated with the delivery of the Plan to meet its objective of providing an opinion on the efficacy of the Council's risk management, internal control and governance.

An Executive Summary of the final Internal Audit assurance reports issued, including audit objective, findings, good practice and recommendations (where appropriate), and the Chief Internal Auditor's independent and objective opinion on the adequacy of the control environment and governance arrangements within each audit area, is shown in Appendix 1.

The MLC Internal Audit function conforms to the professional standards as set out in Public Sector Internal Audit Standards (PSIAS) (2017), including the production of this report to communicate the audit results.

Date 13 January 2022

Report Contact:

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3 Progress Report

- 3.1** The Internal Audit Annual Plan 2021/22 was approved by the Audit Committee on 9 March 2021. Internal Audit has carried out the following work in the period from 1 November to 31 December 2021 associated with the delivery of the Plan to meet its objective of providing an opinion on the efficacy of the Council's risk management, internal control and governance.
- 3.2** The MLC Internal Audit function conforms to the professional standards as set out in Public Sector Internal Audit Standards (PSIAS) (2017) including the production of this report to communicate the audit results.
- 3.3** Internal Audit issued final assurance reports on the following subjects:
- Income Collection
 - Digital Learning Strategy and Equipped for Learning Project
- 3.4** An Executive Summary of the final Internal Audit assurance report issued, including audit objective, findings, good practice and recommendations (where appropriate), and the Chief Internal Auditor's independent and objective opinion on the adequacy of the control environment and governance arrangements within each audit area, is shown in Appendix 1.

The definitions for Internal Audit assurance categories are as follows:

Level	Definition
Comprehensive assurance	Sound risk, control, and governance systems are in place. These should be effective in mitigating risks to the achievement of objectives. Some improvements in a few, relatively minor, areas may be required.
Substantial assurance	Largely satisfactory risk, control, and governance systems are in place. There is, however, some scope for improvement as current arrangements could undermine the achievement of objectives or leave them vulnerable to error or misuse.
Limited assurance	Risk, control, and governance systems have some satisfactory aspects. There are, however, some significant weaknesses likely to undermine the achievement of objectives and leave them vulnerable to an unacceptable risk of error or misuse.
No assurance	The systems for risk, control, and governance are ineffectively designed and operated. Objectives are not being achieved and the risk of serious error or misuse is unacceptable. Significant improvements are required.

Current Internal Audit Assurance Work in Progress

- 3.5** Internal Audit assurance work in progress to deliver the Internal Audit Annual Plan 2021/22 consists of the following:

Audit Area	Audit Stage
Early Learning and Childcare Expansion	Draft report issued
Scottish Welfare Fund	Draft report issued
Sustainable Environment	Testing underway
Information Governance	Testing underway
ICT and Cyber Security	Testing underway
Waste and Recycling Services	Testing underway
Housing Allocations	Testing underway
Capital Investment	Testing underway
Business Continuity	Testing underway
Learning and Physical Disabilities Services	Planning & research
Adult Social Care Contract Monitoring	Planning & research
Schools (cyclical assurance audit)	Defer to 2022/23

Internal Audit Consultancy and Other Work

- 3.6** Internal Audit staff have been involved in the following for the Council to meet its aims and objectives, and its roles and responsibilities in accordance with the approved Internal Audit Charter and Strategy:
- In its critical friend role provided an independent view and challenge at various forums including Business Transformation Board, Capital Plan and Asset Management Board, and Information Management Group.
 - Learning and development during the research stage of new audit areas for all Internal Audit team members and through joining virtual audit forums and meetings.
 - Carried out background research and engagement associated with the ongoing review and enhancement of the Council's Performance Management Framework (PMF). Internal Audit will continue to have oversight on any changes to the PMF and will include an assurance audit in its Annual Plan 2022/23 to critically evaluate the revised PMF and test a sample of performance indicators in Service Plans 2022/23 to validate their relevance, completeness and accuracy.

Recommendations

- 3.7** Recommendations in reports are suggested changes to existing procedures or processes to improve the controls or to introduce controls where none exist. The grading of each recommendation reflects the risk assessment of non-implementation, being the product of the likelihood of the risk materialising and its impact:

High: Significant weaknesses in existing controls, leaving the Council or Service open to error, fraud, financial loss or reputational damage, where the risk is sufficiently high to require immediate action within one month of formally raising the issue. Added to the relevant Risk Register and included in the relevant Assurance Statement.
Medium: Substantial weaknesses in existing controls, leaving the Council or Service open to medium risk of error, fraud, financial loss or reputational damage requiring reasonably urgent action within three months of formally raising the issue.
Low: Moderate weaknesses in existing controls, leaving the Council or Service open to low risk of error, fraud, financial loss or reputational damage requiring action within six months of formally raising the issue to improve efficiency, effectiveness and economy of operations or which otherwise require to be brought to attention of senior management.
Outwith the report, Internal Audit informs operational managers about other matters as part of continuous improvement.

- 3.8** The table below summarises the number of Internal Audit recommendations made during 2021/22:

	2021/22 Number of Recs
High	0
Medium	2
Low	3
Sub-total reported this period	5
Previously reported	23
Total	28
Recommendations agreed with action plan	28
Not agreed; risk accepted	0
Total	28

4 Report Implications (Resource, Digital, Risk and Equalities)

4.1 Resource

Resource implications of implementing Internal Audit recommendations are considered as part of the audit process to ensure these are reasonable and proportionate to the risks.

4.2 Digital

There are no digital implications arising from this report.

4.3 Risk

The PSIAS require Internal Audit to evaluate the effectiveness of the Council's Risk Management arrangements and contribute to improvements in the process. At the start of each audit engagement, to capture potential areas of risk and uncertainty more fully, key stakeholders have been consulted and risk registers have been considered. During each audit engagement the management of risk has been tested.

It is anticipated that improvements in the management and mitigation of risks will arise as a direct result of Management implementing the Internal Audit recommendations made. If audit recommendations are not implemented, there is a greater risk of financial loss and/or reduced operational efficiency and effectiveness, and Management may not be able to demonstrate improvement in internal control and governance arrangements, and effective management of risks.

4.4 Ensuring Equalities

This report does not relate to a new or revised policy, service or budget change, which affects people (the public or staff), so an Integrated Impact Assessment (IIA) is not an applicable consideration.

The Internal Audit work is carried out in accordance with the appropriate legislation and professional standards. The latter includes compliance by those within the Internal Audit function with the Code of Ethics set out in the PSIAS which is appropriate for the profession of Internal Audit founded as it is on trust placed in its independent and objective assurance about risk management, internal control and governance.

4.5 Additional Report Implications (See Appendix A)

APPENDIX A – Additional Report Implications

A.1 Key Priorities within the Single Midlothian Plan

Although this report does not relate directly to the key priorities within the Single Midlothian Plan to which Midlothian Council and its Community Planning Partners have made a commitment (Reducing the gap in economic circumstances; Reducing the gap in learning outcomes; Reducing the gap in health outcomes; and Reducing the impact of climate change), good governance is important to enable Midlothian Council to deliver its key priorities in support of achieving the Council's objectives.

A.2 Key Drivers for Change

Key drivers addressed in this report:

- ☒ Holistic Working
- ☒ Hub and Spoke
- ☒ Modern
- ☒ Sustainable
- ☒ Transformational
- ☒ Preventative
- ☒ Asset-based
- ☒ Continuous Improvement
- ☒ One size fits one
- ☐ None of the above

Midlothian Council is committed to creating a great place to grow supported by the 9 drivers for change. Implementing the 9 drivers for change in practice is applicable to the Council's Internal Audit service provision to assist the Council in achieving its objectives.

A.3 Key Delivery Streams

Key delivery streams addressed in this report:

- ☒ One Council Working with you, for you
- ☒ Preventative and Sustainable
- ☒ Efficient and Modern
- ☒ Innovative and Ambitious

A.4 Delivering Best Value

The definition of Internal Auditing within the Public Sector Internal Audit Standards (PSIAS) is "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes."

Implementation by Management of the actions associated with Internal Audit recommendations, that are designed to improve internal control and governance arrangements and management of risks, underpins the Council's own continuous improvement arrangements to enhance its effectiveness, thus supporting the delivery of the Council's best value duties.

A.5 Involving Communities and Other Stakeholders

The Chief Internal Auditor is accountable to the Audit Committee which, in fulfilling its governance role, acts as a bridge between the Council and other stakeholders.

This report has been presented to the Corporate Management Team to outline the key messages of assurance and areas of improvement. Senior Management relevant to the areas audited have agreed the final Internal Audit assurance reports as set out in the relevant Executive Summary within Appendix 1.

A.6 Impact on Performance and Outcomes

The Findings and Recommendations from Internal Audit work during the year are designed to assist the Council in improving its performance and outcomes.

A.7 Adopting a Preventative Approach

Internal Audit assurance work includes assessments on when a preventative approach can be adopted.

A.8 Supporting Sustainable Development

This report does not relate directly to supporting sustainable development. Good governance is important to enable Midlothian Council to achieve its objectives.

Report	Summary of key findings and recommendations	Recommendations			Status
		H	M	L	
<p>Subject: Income Collection</p> <p>Category: Assurance – Cyclical b/f 2020/21</p> <p>Date issued: 01 December 2021 Draft; 20 December 2021 Final</p> <p>Level of Assurance: Substantial</p>	<p>The purpose of this assurance audit was to review the collection of income and the Council's compliance with the Payment Card Industry Data Security Standard (PCI DSS) Standards. The audit included a review of the Parent-Pay system, and a follow up of the 4 recommendations made in the Sales to Cash audit issued in May 2019.</p> <p>Customers are encouraged to pay by direct debit or by debit / credit card online or by using the automated telephone system. A customer service platform project is underway to replace the CRM system and allow more online payments to be processed in line with the Digital Strategy.</p> <p>The Council is not yet fully PCI compliant. The risk of card data compromise has been reduced significantly through the outsourcing of the card payment processes to third party processors and by applying additional technical and organisational controls. A number of projects and discussions are ongoing with Civica and MasterCard to ensure online payments are processed more securely and meet the Strong Customer Authentication (SCA) requirements.</p> <p>Internal Audit considers that the level of assurance is Substantial; there are adequate and effective systems of control for the identification, recording and banking of income, and any payments which do not reconcile are investigated. Two of the four recommendations in the Sales to Cash audit issued in May 2019 have been actioned satisfactorily and the other two are in process and scheduled for completion by March 2022.</p> <p>Internal Audit made the following recommendations:</p> <ul style="list-style-type: none"> • The PCI DSS Compliance risk register should be reviewed and updated on the Pentana Performance system to reflect the risk score and control measures in place for employees processing payments while working remotely (Low) • The reporting facility within Parent-Pay should be utilised. Schools should ensure that all payments are recorded on the system and encourage parents to sign up to Parent-Pay. Further training to schools on the use of the system including reconciling online payments should be provided. (Low) • The procurement process should be undertaken to cover the current coin, cash and cheque collection requirements. (Low) 	0	0	3	Management have accepted the findings of the report and have agreed to implement the recommendations.

Report	Summary of key findings and recommendations	Recommendations			Status
		H	M	L	
<p>Subject: Digital Learning Strategy and Equipped For Learning Project</p> <p>Category: Assurance – Risk</p> <p>Date issued: 07 December 2021 Draft; 13 January 2022 Final</p> <p>Level of Assurance: Substantial</p>	<p>The purpose of this assurance audit was to review the roles and responsibilities and governance of the project to ensure that the digital learning rollout is aligned to Council priorities and business requirements.</p> <p>In May 2016 the Council published its strategy for digital learning: Learning in a Digital Age. The core principles underpinning the strategy are: digital innovation; digital literacy; together with learning and engagement. The Equipped for Learning Project initiated in May 2021, whilst the Education service review was underway and recruitment was taking place for the new Digital Learning and Inclusion team. The Council aims to provide every school age pupil living in Midlothian with a learning device such as an iPad or Google Chromebook as part of the Council's £10.5 million investment in digital learning.</p> <p>Internal Audit considers the level of assurance is Substantial - objectives, required outcomes, and roles and responsibilities for delivery of the Equipped for Learning Project are clearly set out, although criteria for success are yet to be agreed for some outcomes and IT professionals associated with the project consider delivery timescales to be very challenging. Project governance arrangements in place have yet to fully catch up with delivery of the first phase of the project but are now sufficiently advanced to be considered effective, particularly for future phases. The Council's established project governance arrangements for capital projects should be applied to all subsequent phases of the project.</p> <p>Internal Audit made the following recommendations:</p> <ul style="list-style-type: none"> • The Equipped for Learning project, once delivered, will have substantial implications for strategies in place including the Digital Learning Strategy and the Learning Estate Strategy. These strategies should be updated to reflect the impact of the project and provide a framework for future developments. (Medium) • The Council's established project governance arrangements for capital projects applicable to a project of this value should be applied to all subsequent phases of the project, including set out criteria for success for some outcomes on completion of the full business case, conduct gateway reviews at key milestones in the project plan, and ensure appropriate reporting to relevant Boards. (Medium) 	0	2	0	<p>Management Response: In general the findings are accurate and the recommendations are accepted with actions underway to implement the improvements; however, for context this is a complex project involving multiple teams to achieve business transformation and change with capital investment in technology to enable that transformation and change.</p>

Counter Fraud Controls Assessment 2021/22**Report by Kevin Anderson, Executive Director Place****Report for Decision****1 Recommendations**

The Audit Committee:

- a) Acknowledge the findings from the Integrity Group's assessment of counter fraud controls 2021/22 in response to fraud risks; and
- b) Endorse the necessary actions to enhance the Council's resilience to fraud, as summarised in the Action Plan in Appendix B.

2 Purpose of Report/Executive Summary

The purpose of the report is to make the Audit Committee aware of the findings and necessary actions arising from the Integrity Group's assessment of counter fraud controls.

Having robust fraud prevention and investigation arrangements in place contributes to safeguarding the Council's resources, for delivery of services, as part of protecting the public purse. A focus on enhancing fraud prevention and detection to improve Midlothian Council's resilience to the risk of fraud, theft, corruption and crime (including cybercrime and money laundering), and ensure these are embedded preventative practices, as specific changes associated with the Counter Fraud Strategy approved by Council in August 2020.

The primary responsibility for the prevention, detection and investigation of fraud rests with Management, supported by the Integrity Group, whose purpose is to improve the Council's resilience to fraud. One way it can achieve that is self-assessing the Council's arrangements against best practice and agreeing any appropriate actions to continuously improve the arrangements in place.

Assurances about the effectiveness of the Council's existing systems and arrangements for the prevention, detection and investigation of fraud can be taken from the contents this report.

Date 7 January 2022

Report Contact:

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3 Background

- 3.1** The size and nature of the Council's services, as with other large organisations, puts the Council at risk of loss due to fraud, theft, corruption, or crime. The Council at its meeting on 25 August 2020 approved a refreshed Counter Fraud Policy Statement and Counter Fraud Strategy, which had been endorsed by the Audit Committee on 22 June 2020 along with the Terms of Reference of the new Integrity Group. The Council's Counter Fraud Policy states the roles and responsibilities in tackling fraud; the primary responsibility for the prevention, detection and investigation of fraud rests with Management.
- 3.2** Having robust fraud prevention and investigation arrangements in place contributes to safeguarding the Council's resources, for delivery of services, as part of protecting the public purse. A focus on enhancing fraud prevention and detection to improve Midlothian Council's resilience to the risk of fraud, theft, corruption and crime (including cybercrime and money laundering), and ensure these are embedded preventative practices, as specific changes associated with the Counter Fraud Strategy.
- 3.3** Tackling fraud is a continuous process across all parts of the Council because the service delivery processes it underpins are continuous.
- 3.4** The Integrity Group is an officer forum chaired by the Executive Director Place and currently has representatives from HR, Finance, Legal, IT, Procurement, Internal Audit and Corporate Fraud to support Management to fulfil their responsibilities in tackling fraud. Bi-monthly meetings were held during 2021 to fulfil its functions as set out in its Terms of Reference.
- 3.5** Internal Audit is required to give independent assurance of the effectiveness of processes put in place by Management to manage the risk of fraud.
- 3.6** Part of the Audit Committee's role is to oversee the adequacy of the risk management framework and the internal control environment, including the assessment of fraud risks and potential harm to the Council from fraud and corruption and to monitor the counter-fraud strategy, actions and resources.
- 3.7** The Integrity Group carried out an assessment in 2020/21 of counter fraud controls associated with the covid-19-emerging-fraud-risks. The findings from which were reported to the Audit Committee on 9 March 2021, along with the necessary actions to enhance the Council's resilience to fraud, theft, corruption, and crime.
- 3.8** The Audit Committee, at its meeting on 28 September 2021, considered the Audit Scotland report 'Fraud and Irregularity Update 2020/21' (published 1 July 2021) and assigned some tasks to the Integrity Group associated with the Audit Scotland report and to request an assurance report thereon.

4 Self-Assessment 2021/22 Findings and Necessary Actions

- 4.1** The Integrity Group considered the Audit Scotland report 'Fraud and Irregularity Update 2020/21' on 27 October 2021 to determine any Management Actions required in response for improvement and assurance purposes. It noted the similarities in the fraud risks reported in 2020 and 2021 by Audit Scotland. It revisited the Counter Fraud Controls Assessment carried out during 2020/21 to provide a progress update on the agreed Action Plan at its next meeting.
- 4.2** The Integrity Group on 8 December 2021 received a progress update on the Action Plan from each of the Integrity Group Action Owners along with further information on additional practices that have been introduced since the counter fraud controls assessment carried out during 2020/21. The output from that is included within Appendix B. The Integrity Group considered this report in draft on 11 January 2022, prior to its presentation to Corporate Management Team on 12 January 2022 and onwards to Audit Committee 25 January 2022.
- 4.3** Assurances about the effectiveness of the Council's existing systems and arrangements for the prevention, detection and investigation of fraud can be taken from the contents of this report. The Integrity Group will continue to monitor progress with implementation of Actions, noting that some are continuous across the Council.

5 Report Implications (Resource, Digital, Risk and Equalities)

5.1 Resource

The Integrity Group will support Management across the Council with counter fraud management by: overseeing the review of the counter fraud policy framework in line with best practice; highlighting emerging fraud and corruption risks, threats, vulnerabilities; agreeing fraud and corruption mitigation actions; raising awareness of bribery, fraud and corruption in the Council as a method of prevention; meeting during the course of fraud investigations with the aim to take corrective action, minimise losses and help prevent further frauds; and coordinating with the Serious Organised Crime (SOC) Group.

5.2 Digital

None.

5.3 Risk

The Council is committed to minimising the risk of loss due to fraud, theft, corruption or crime and to taking appropriate action against those who attempt to defraud the Council, whether from within the authority or from outside.

The Counter Fraud Policy Statement sets out the roles and responsibilities for the prevention, detection and investigation of fraud. The Counter Fraud Strategy provides a shift in approach to focus on enhancing fraud prevention and detection to improve Midlothian

Council's resilience to the risk of fraud. The steer provided by the Integrity Group and the work undertaken by the Corporate Fraud Team in collaboration with other Services is designed to reduce the fraud risks within the Council.

The Integrity Group's assessment of counter fraud controls associated with the covid-19-emerging-fraud-risks contained in this report is designed to provide assurance to Management and the Audit Committee on the efficacy of Midlothian Council's arrangements, and sets out the actions that are ongoing or required to enhance the Council's resilience to fraud. The Integrity Group agreed the content of this report at its meeting on 9 February 2021.

The Integrity Group will carry out a further review of these fraud risks and any other emerging fraud risks relating to Covid-19 in due course, to ensure the controls continue to be effective in mitigating the risks. This will include the receipt, consideration and monitoring of organisational vulnerability alerts or fraud flags, including those identified via various internal and external sources.

5.4 Ensuring Equalities

An Integrated Impact Assessment (IIA) Form was completed prior to the presentation of the revised Counter Fraud Policy and Strategy that were approved by the Council on 25 August 2020.

5.5 Additional Report Implications (See Appendix A)

APPENDIX A – Additional Report Implications

A.1 Key Priorities within the Single Midlothian Plan

Although this report does not relate directly to the key priorities within the Single Midlothian Plan (Reducing the gap in economic circumstances; Reducing the gap in learning outcomes; Reducing the gap in health outcomes; and Reducing the impact of climate change) by preventing and detecting fraud, additional resources might be available to support the Council's objectives. Any loss of funds due to fraud, theft, corruption or crime might impact on the ability of Midlothian Council to achieve its key priorities.

A.2 Key Drivers for Change

Key drivers addressed in this report:

- ☒ Holistic Working
- ☒ Hub and Spoke
- ☒ Modern
- ☒ Sustainable
- ☒ Transformational
- ☒ Preventative
- ☒ Asset-based
- ☒ Continuous Improvement
- ☒ One size fits one
- ☐ None of the above

Midlothian Council is committed to creating a great place to grow supported by the 9 drivers for change. Implementing the 9 drivers for change in practice is applicable to the Council's arrangements for tackling fraud as set out in the Counter Fraud Policy Statement and Counter Fraud Strategy. The shift to the key drivers for change is an intrinsic part of the proposed change in approach and culture for the Council for tackling fraud and corruption. For example:

- (a) The formal establishment of an Integrity Group with a Terms of Reference (approved by the Audit Committee on 22 June 2020) shifting to more holistic working in multi-disciplinary forums to tackle fraud in a consistent and collaborative way across the Council;
- (b) A focus on enhancing fraud prevention and detection to improve Midlothian Council's resilience to the risk of fraud, theft, corruption, and crime and ensure these are embedded preventative practices;
- (c) Applying the minimum standard within the CIPFA Code of Practice on 'Managing the Risk of Fraud and Corruption (2014)' for counter fraud policy, strategy and other practices, and adopting the CIPFA Counter Fraud Maturity Model as a means of self-assessment moving forward will enable continuous improvement to be evaluated, managed and evidenced; and
- (d) Use of a blend of toolkits such as fraud vulnerability assessments and e-learning packages that can be tailored to specific Services.

A.3 Key Delivery Streams

Key delivery streams addressed in this report:

- ☒ One Council Working with you, for you
- ☒ Preventative and Sustainable
- ☒ Efficient and Modern
- ☒ Innovative and Ambitious

A.4 Delivering Best Value

Having robust fraud prevention and investigation arrangements in place contributes to safeguarding the Council's financial resources, for delivery of services, as part of protecting the public purse. The Counter Fraud Strategy states the Council will measure progress against the CIPFA Counter Fraud Maturity Model as a self-assessment approach to continuous improvement in order to be evaluated, managed and evidenced to demonstrate best value in the use of resources.

A.5 Involving Communities and Other Stakeholders

Ensuring awareness of the Whistleblowing facility to report areas of concern is important in the approach to tackling fraud. The facility has been promoted in recent years and is being utilised by staff, those within communities or other stakeholders.

A.6 Impact on Performance and Outcomes

The primary responsibility for the prevention, detection and investigation of fraud rests with Management, supported by the Corporate Fraud team. Internal Audit provides advice and independent assurance on the effectiveness of processes put in place by Management. The Findings and Recommendations from Internal Audit and Corporate Fraud work which are presented to the Audit Committee during the year assists the Council in maintaining and / or enhancing fraud prevention and detection controls.

A.7 Adopting a Preventative Approach

Having robust fraud prevention and investigation arrangements in place contributes to safeguarding the Council's financial resources, for delivery of services, as part of protecting the public purse. A focus on enhancing fraud prevention and detection to improve Midlothian Council's resilience to the risk of fraud, theft, corruption and crime, and ensure these are embedded preventative practices are specific changes associated with the Counter Fraud Strategy.

A.8 Supporting Sustainable Development

None.

APPENDIX B

Risk Area	Action required to enhance existing Fraud Risk Controls 2020/21	Integrity Group Action Owner	Progress Update 2021/22
General Governance	The necessary action is the update of Financial Regulations (2012) and Financial Directives, as indicated in the report 'Annual Governance Statement – Financial Improvement Update' to the Audit Committee on 8 December 2020 by the Chief Officer Corporate Solutions.	Financial Services Manager	Update of Financial Regulations (2012) and Financial Directives - planned for end March 2022.
Procurement	The necessary action is to strengthen the capacity and skills in the Procurement Team through recruitment and an engagement with Scotland Excel, as indicated in the report 'Annual Governance Statement – Financial Improvement Update' to the Audit Committee on 8 December 2020 by the Chief Officer Corporate Solutions.	Chief Procurement Officer	A Chief Procurement Officer commenced in post in September 2021. He is undertaking an initial assessment of service provision, resources and areas of improvement.
Payroll-Recruitment	There is ongoing staff and other stakeholder communications to remind them of the wellness supports that are available, and ongoing supervision and training.	HR Manager	Partnership working underway with The Money and Pensions Service to ensure the workforce received reputable advice and guidance.
IT-Cyber Crime	Continued periodic emails reminding staff of their responsibilities, and guidance on what to do.	Information Governance/Security Services Lead	Continued periodic emails reminding staff of their responsibilities. Staff are required to undertake new mandatory Cyber Security training available on LearnPro by December 2021.
	There is ongoing monitoring of the effectiveness of the technical and organisational controls and continuous monitoring of the threat landscape.	Information Governance/Security Services Lead	The Information Governance/ Security Services Lead attends Scottish Local Authority Information Security Group (SLAISG) quarterly meetings. Assessment underway of the SEPA lessons learned report by SG Digital Office to determine required actions.

Risk Area	Action required to enhance existing Fraud Risk Controls 2020/21	Integrity Group Action Owner	Progress Update 2021/22
Health & Wellbeing	There is ongoing staff and other stakeholder communications to remind them of the wellness supports that are available, and ongoing supervision and training.	HR Manager	Ongoing staff and other stakeholder communications to remind them of the wellness supports that are available, and ongoing supervision and training. Organisational Wellbeing Strategy to be launched in January 2022 along with the Making it Happen Network encouraging staff to 'be their best selves' and 'do their best work'.
	Sharing best practice and learning lessons from other organisations.	HR Manager	Action plan currently being developed following the Independent Inquiry at the City of Edinburgh Council concerning claims of harassment and other forms of discrimination not being taken seriously during periods of extreme pressure. To be presented to CMT in January 2022.
Wider Risks	Public awareness campaigns from the Scottish Government, Action Fraud, National Cyber Security Centre (NCSC) and others alert people to the dangers of phishing emails and texts and cold calling from fraudsters. These are ongoing.	Information Governance/Security Services Lead	Ongoing as relevant within weekly staff communications.

External Audit Annual Report to Members and the Controller of Audit for the year ended 31 March 2021 – Update on recommendations

Report by Gary Fairley Chief Officer Corporate Solutions

Report for Noting

1 Recommendations

Audit Committee are asked to note this update on the recommendations which were set out in the External Auditor's report for the year ended 31 March 2021.

2 Purpose of Report/Executive Summary

At its meeting of 28 September 2021 the Audit Committee considered the External Auditor's Annual Report to Members and the Controller of Audit for the year ended 31 March 2021.

Arising from that the Audit Committee action log recorded an action for a progress report to be brought back to the Committee in January 2022 on the implementation and progress of the External Auditor's recommendations.

6 January 2022

Report Contact:

Gary Fairley
gary.fairley@midlothian.gov.uk

3 Background

In accordance with the Local Government (Scotland) Act 1973, the Accounts Commission appointed EY as the external auditor of Midlothian Council with the appointment extended by 12 months to encompass financial year 2021/22.

EY undertake the audit in accordance with the Code of Audit Practice (the Code), issued by Audit Scotland in May 2016; Auditing Standards and guidance issued by the Financial Reporting Council; relevant legislation; and other guidance issued by Audit Scotland.

Each year they prepare an Annual Audit Report that summarises the key findings and conclusions from their audit work. The report is addressed to both members of the Council and the Controller of Audit, and presented to those charged with governance. The final report is provided to Audit Scotland and is published on their website.

Audit Committee considered the report for financial year ending 31 March 2021 on 28th September 2021 with full Council considering the report on 16th November 2021.

4 Progress with Recommendations in the Annual Report

Appendix D to the Annual Report included an action plan which summarised specific recommendations included within the body of the Annual Audit Report. These were graded according to the Auditors consideration of their priority for the Council or management to action.

Grade 1: Key risks and / or significant deficiencies which are critical to the achievement of strategic objectives. Consequently management needs to address and seek resolution urgently.	Grade 2: Risks or potential weaknesses which impact on individual objectives, or impact the operation of a single process, and so require prompt but not immediate action by management.	Grade 3: Less significant issues and / or areas for improvement which we consider merit attention but do not require to be prioritised by management.
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There were four recommendations made in the 2021 report. These are set out below together with an update on progress with implementation:

Findings and / or risk	Recommendation/ grading	Management response / Implementation timeframe	Progress Update
1. The accounting for assets which are subject to revaluation continues to be an area of significant estimation uncertainty.	The completion in 2020/21 of the revaluation of the major aspects of the Council's assets, would be an opportunity for the Council to consider its approach going forward as a matter of good practice. This review may include: <ul style="list-style-type: none"> Reducing the time between full valuations 	Accepted. A review of the asset valuation arrangements will be undertaken in preparation for the 2021/22 year end. Changes arising will be reflected in the formal engagement with the internal valuation team and	This action will be completed as planned by 31 March 2022 and the revised asset valuation arrangements will be reflected in the formal engagement with the internal valuation team. In addition, CMT on 22 December 2021 considered a report on the arrangements for

	<p>for all major individual asset classes;</p> <ul style="list-style-type: none"> • Applying indexation increases on assets not fully valued in the year to reflect some estimate of the movement in their value between formal valuations; and • Ensuring up-to-date condition surveys are in place for all assets. <p>Grade 2</p>	<p>in the final accounts project plan.</p> <p>Responsible officer: Chief Officer, Corporate Solutions</p> <p>Implementation date: 31 March 2022</p>	<p>condition surveys and agreed to recommend to Council an increase in the annual budget to help ensure that are kept up to date.</p>
<p>2. We noted there may be scope to review the current structure of the Governance Statement against good practice outlined within CIPFA's Delivering Good Governance Guidance. This includes ensuring that the statement captures the key strategic challenges and risks that face the Council and communicating significant issues alongside an action plan for improvement.</p>	<p>While the Annual Governance Statement is in line with current requirements, there is an opportunity to review the structure to ensure that it better reports on the achievement of strategic priorities and reflects areas of significant risk and challenge.</p> <p>Grade 3</p>	<p>Response: Accepted. In preparation for the 2021/22 Annual Governance Statement a review of the structure will be undertaken and changes reflected in the draft Annual Governance Statement for 2021/22</p> <p>Responsible officer: Chief Internal Auditor/Legal Services Manager</p> <p>Implementation date: May 2022</p>	<p>Meetings between relevant officers have been set up to facilitate the Annual Assurance Process for 2021/22 to ensure the Annual Governance Statement continues to meet CIPFA's Delivering Good Governance Guidance requirements.</p>
<p>3. We note that the role and membership of the Audit Committee should be considered by the new Council, following local government elections in May 2022. There is no prescribed structure for Audit Committees within local government as the structure can vary depending on the political environment. Other councils in Scotland adopt wider remits for equivalent committees, including a focus on finance, risk and Best Value.</p>	<p>The Council should review Audit Committee arrangements post election to ensure that governance arrangements reflect the political and strategic environment.</p> <p>Grade 2</p>	<p>Response: Accepted. The review will form part of the review of Standing Orders and the Scheme of Delegation in preparation for the next term of Council.</p> <p>Responsible officer: Executive Director Place</p> <p>Implementation date: May 2022</p>	<p>A report was presented to Council on 14 December 2021 which provided an update on the work of the Standing Orders Working Group, noting that the group had agreed draft revised Standing Orders and a Scheme of Administration but it is considered that further revisions were required to reflect supervening events.</p> <p>The review of Audit Committee arrangements will be considered as part of the wider review of governance arrangements in preparation for the next term of Council after the May 2022 election.</p>
<p>4. Quarterly and annual performance reports presented to Cabinet and Performance, Review and Scrutiny</p>	<p>Officers should work with members to ensure performance reports are presented in a manner which</p>	<p>Response: Accepted. Work is underway to progress dashboards which</p>	<p>Dashboards are now used to supplement the narrative reports for Cabinet and Performance</p>

Committee are heavily narrative based. Council officers have been exploring alternative formats for presenting data including the introduction of graphics such as charts, trend analysis however, Committee reports, which are also publicly available continue to contain significant narrative analysis.	<p>supports effective challenge and scrutiny, including through the use of more graphical presentations.</p> <p>Grade 3</p>	<p>will supplement quarterly reporting data currently available to elected members via 'Pentana Browser'. In addition, these will be publicly available ensuring more timely and accessible performance information is published on the Council's website. The intention is to introduce dashboards as part of improvements for the performance management cycle for 2022/23.</p> <p>Responsible officer: Continuous Improvement Manager</p> <p>Implementation date: September 2022</p>	<p>Review and Scrutiny Committee.</p> <p>The intention remains too shift fully to these graphic version of reports after the May 2022 elections.</p>
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The report also noted that there were three ongoing recommendation from previous years

Findings and / or risk	Management response / Implementation timeframe	Our assessment of progress	Progress Update
Continued work is required to finalise a medium-term financial plan, underpinned by identified and agreed budget savings over the term of the plan to not only manage in year financial positions, but also to ensure that the forecast pressures are addressed on a timely basis. The Council must continue to develop a balanced MTFP in the medium to long term.	<p>Agreed. Officers continue to support BTSG to recommend measures to Council to achieve a balanced MTFS.</p> <p>Responsible officer: BTSG</p> <p>Implementation date: 11 February 2020</p> <p>Grade 1</p>	<p>While plans are in place for the 2021/22 and 2022/23 budgets, the Council is relying on one-off measures. Significant work is required to develop a revised MTFS for the next administration.</p> <p>Our assessment: Ongoing</p>	<p>On the recommendation of BTSG Council agreed the budget for 2021/22.</p> <p>Council has considered two reports in respect of the 2022/23 budget which incorporated recommendations from BTSG to Council. Council is scheduled to determine the 2022/23 budget and Council Tax levels on 15 February 2022 with BTSG meeting on 25th January 2022 to determine its recommendations to Council.</p> <p>As highlighted in the CIPFA Financial Management Model assessment reported to Audit committee on 7 December 2021 development continues on</p>

			<p>the financial strategy for the term of the next Council with the aim of presenting options to elected members after the May 2022 elections.</p> <p>Status; Ongoing with completion expected after May 2022.</p>
<p>The Council continues to experience timing and data accuracy issues in relation to feeder financial information systems. The Council must ensure that services apply greater rigour to feeder financial systems to support improved reporting.</p>	<p>Agreed. As part of the review of the 2018/19 year end an issue and lessons learnt report is being prepared which will set out recommendations for future improvement required for 2019/20 year end.</p> <p>Responsible officer: Head of Finance & ISS</p> <p>Implementation date: 31 March 2020</p> <p>Grade 2</p>	<p>Within Financial Management, we noted that the level of variation in financial monitoring reports noted in prior years did not occur, signalling improved financial forecasting and control.</p> <p>Our assessment: Ongoing</p>	<p>Significant progress has been made in resolving service specific issues leading to more reliable in year reporting of service and financial performance as was recognised by External Audit.</p> <p>Where issues are identified that limit the ability to provide Service, CMT and Council with robust financial projections on any area of activity these are reported to the quarterly Financial Monitoring CMT meetings and appropriate actions identified to address these.</p> <p>A broadly similar internal audit action has been agreed by Internal Audit as complete.</p> <p>Status; Completed</p>
<p>The Best Value Assurance Report highlighted that there is scope to be clearer about priority indicators and targets to track the Council's performance. The Council should ensure that performance reporting arrangements support elected member scrutiny.</p>	<p>Responsible officer: Quality & Scrutiny Manager</p> <p>Implementation date: 31 March 2020</p> <p>Grade 3</p>	<p>While significant improvements have been made to the Council's performance reporting capability, we note within the Value for Money section that there is scope to refine key performance measures and targets.</p> <p>Our assessment: Ongoing</p>	<p>The Council continues to deliver its priorities through the Community Planning Partnership and the Single Midlothian Plan, which was supplemented during the pandemic by the Route Map through and out of the crisis and Midlothian's Listen and Learn report. As a result, Service Plans for 2021/22 have been developed and informed by these key strategic documents, ensuring alignment with SMP/ Strategic priorities and associated service priorities and performance measures. In addition, in developing Service Plans for the 2021/22 cycle, Chief Officers were also tasked with reviewing SMP and Balanced</p>

			<p>Scorecard indicators to further refine and align key measures and indicators.</p> <p>In line with the need to present a financial strategy for the term of the next Council, CMT is also developing a 5 year strategic plan with the aim of presenting this to elected members after the May 2022 elections. This, alongside existing key strategic documents, will be used to inform the 2022/23 Service Planning Cycle to better inform and target performance measures and targets.</p> <p>Status; Ongoing with completion expected after May 2022.</p>
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5 Report Implications (Resource, Digital and Risk)

5.1 Resource

There are no direct resource implications arising from this report. The continued areas of improvements will be met from existing resources.

5.2 Digital

There are no direct digital implications arising from this report.

5.3 Risk

There are no specific risks arising from this report. The progress outlined in the report strengthens the Council's financial management and governance arrangements and in turn supports effective mitigation of risk.

5.4 Ensuring Equalities (if required a separate IIA must be completed)

There have been no changes to policies which require an IIA to be completed.

5.5 Additional Report Implications (See Appendix A)

See Appendix A

Appendices

Appendix A – Report Implications

APPENDIX A – Report Implications

A.1 Key Priorities within the Single Midlothian Plan

Maintaining effective financial governance and effective internal controls are central to demonstrating strong financial management and financial sustainability and it is on these foundations that delivery of the priorities in the Single Midlothian Plan is based.

A.2 Key Drivers for Change

Key drivers addressed in this report:

- ☐ Holistic Working
- ☐ Hub and Spoke
- ☒ Modern
- ☒ Sustainable
- ☒ Transformational
- ☐ Preventative
- ☐ Asset-based
- ☒ Continuous Improvement
- ☐ One size fits one
- ☐ None of the above

A.3 Key Delivery Streams

Key delivery streams addressed in this report:

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

A.4 Delivering Best Value

Effective Financial Governance is a core principal of Best Value.

A.5 Involving Communities and Other Stakeholders

There has been no external engagement in preparing this report.

A.6 Impact on Performance and Outcomes

In the main the arrangements set out in the report do not have a direct impact on performance or outcomes.

A.7 Adopting a Preventative Approach

Maintaining an effective Financial Governance and internal control arrangements is central to the prevention of error and or the risk of fraud.

A.8 Supporting Sustainable Development

No direct impact.

Shared Internal Audit Services and Proposed Way Forward 2022/23**Report by Chief Executive****Report for Noting****1 Recommendations**

The Audit Committee is asked to:

- a) Note the wider options of joint working that have been explored since the 12 month pilot shared Internal Audit services arrangement and the evaluation associated with the provision of Internal Audit services; and
- b) Note that the Corporate Management Team has endorsed the proposal to mutual opt out of the Shared Internal Audit Services at the end of 2021/22, and progress to a permanent staff resourcing of the Internal Audit team of 1 FTE Chief Internal Auditor and 1 FTE AN Other Internal Auditor to maintain Internal Audit FTE staffing from 2022/23 onwards at the current level (2021/22 - 775 days). This will ensure provision of Internal Audit services to, and delivery of the Internal Audit Annual Plans for, Midlothian Council and MIJB.

2 Purpose of Report/Executive Summary

The purpose of this report is to set out an evaluation associated with the provision of Internal Audit services and propose a way forward from 2022/23 onwards.

Shared Internal Audit Services have been provided between Midlothian and Scottish Borders Councils since December 2017. Internal Audit assurance services are also provided by Midlothian Council's Internal Audit team to the Midlothian Integration Joint Board (MIJB).

The operating environment has changed significantly since the inception of the shared Internal Audit services arrangement, in particular over the past 21 months, which provides the opportunity for both Councils to evaluate the arrangement.

The report provides details of the wider options of joint working that have been explored and the evaluation of the shared Internal Audit services arrangement. The report proposes a way forward for 2022/23 onwards for the mutual opt out of the Shared Internal Audit Services at the end of 2021/22 and progress to a permanent staff resourcing of the Internal Audit team to maintain Internal Audit FTE staffing from 2022/23 onwards at the current level (2021/22 - 775 days).

Date 13 January 2022

Report Contact:

Jill Stacey

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3 Background

- 3.1** Councils continue to face significant challenges as a result of constrained funding combined with demographic and other cost pressures associated with current and projected growth. In addition, managing the impact of a number of government policy and legislative changes places additional demands and reinforces the urgent need to change the way Councils operate.
- 3.2** This continues to present an ever growing need to respond in ways that provide the opportunity to 'future proof' services and to create resilience and sustainability within the context of reducing resources.
- 3.3** Under local authority Accounts (Scotland) Regulations 2014 7(1): *"A local authority must operate a professional and objective internal auditing service in accordance with recognised standards and practices in relation to internal auditing"*.
- 3.4** Furthermore, the PSIAS framework defines Internal Audit as follows: *"Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes"*.
- 3.5** The Audit Committee at its meeting on 12 December 2017 agreed to a 12 month pilot arrangement over the sharing of a Chief Internal Auditor post between Midlothian and Scottish Borders Councils. At its meeting on 11 December 2018, the Audit Committee approved the proposal to continue with shared Internal Audit services between Midlothian and Scottish Borders Councils, including the opportunity for a wider exploration of joint working activities and benefits. The shared Internal Audit services arrangement has continued since then, recognising that either Council could still decide to opt out/revert back at any time subject to an appropriate period of notice.
- 3.6** The Internal Audit Strategy and Plan, most recently for 2021/22, set out the Internal Audit staff resources and activity to enable the Chief Internal Auditor, as the Council's Chief Audit Executive (CAE), to provide the statutory annual internal audit opinion regarding the adequacy and effectiveness of internal control within the Council. Internal Audit assurance services are also provided by the Council's Internal Audit team to the Midlothian Integration Joint Board.

4 Evaluation of Shared Internal Audit Services

- 4.1** The challenges and benefits that arose during the 12 month pilot arrangement over the sharing of a Chief Internal Auditor were included in the report 'Shared Internal Audit Services between Midlothian and Scottish Borders Councils', item 5.9 to the Audit Committee on 11 December 2018 [Midlothian Council > Meetings \(cmis.uk.com\)](https://cmis.uk.com)
- 4.2** The operating environment has changed significantly since the inception of the shared Internal Audit services arrangement, in particular over the past 20 months, which provides the opportunity for both Councils to evaluate the arrangement.

- 4.3** To assist with the evaluation of the shared Internal Audit services arrangement, the wider joint working activities that have been explored and the associated outcomes are as follows:
- The principles for development of proposals to expand the current Shared Internal Audit (and Counter Fraud) Services between Midlothian and Scottish Borders Councils to include East Lothian Council were considered in November 2019 by the Corporate Management Teams in each Council. The proposals were not supported by Midlothian Council CMT mainly due to the exacerbation of the challenges of sharing a Chief Internal Auditor from two to three Councils and IJBs, and the impact this might have on the quality of the current shared service provision;
 - The option of shared Risk Management services between Midlothian and Scottish Borders Councils did not progress beyond initial consideration in early 2020 in light of the different approaches within Midlothian and Scottish Borders Councils for the provision of corporate support to Services in the management of risks;
 - The option to deploy Internal Audit team members to work on similar planned audits across the two Councils and IJBs was considered. Due to practical constraints (requirement for IT hardware and access to each organisation's systems and documents), only the Chief Internal Auditor and Interim Specialist Auditor were shared. In addition, the synergies were less than expected due to differences between Councils in their organisation structures and strategies for service delivery, policy framework, and ICT systems. Internal Audit team members continued to work on terms and conditions of their employing authorities.
 - The option for Midlothian Council (MLC) to share Corporate Fraud Officers with Scottish Borders Council (SBC) in light of the vacant Corporate Fraud & Compliance Officer post in SBC since December 2020 due to retirement of the post holder. In light of current workload for the MLC Corporate Fraud Officers, including ongoing fraud investigations, participation in the National Fraud Initiative 2020/2021, and refocus with revised MLC Counter Fraud Policy and Strategy 2020-2023 on fraud prevention and detection, there was insufficient staff resource capacity in the short term.
- 4.4** Additional challenges, such as:
- impact of differences between Councils in the provision of specialist compliance and assurance support services of Internal Audit, Corporate Fraud and Risk Management;
 - the impact of differences between Councils in their governance and management arrangements, which includes the leadership, culture, organisation structures and strategies for service delivery, policy framework, risk appetite, ICT systems, etc.;
 - reduced capacity of the shared Chief Internal Auditor post impacting team management and development, in particular at times when the respective Principal Internal Auditors had unplanned periods of prolonged absence from work. Furthermore, there has been a change in the counter fraud and risk management support staff at Scottish Borders Council, from experienced and empowered post holders to a vacant post and new appointment respectively; and
 - the impact in Midlothian Council of ongoing fraud investigations on capacity to implement new approaches such as those set out in the revised Counter Fraud Policy and Strategy.

- 4.5** In conclusion: the benefits were primarily realised in the first 12 months and have been maintained, though further benefits from joint working options have not been realised in the medium term; and some of the challenges experienced in the short term will continue in the medium term due to differences between Councils in their governance and management arrangements, which includes the leadership, culture, organisation structures and strategies for service delivery, policy framework, risk appetite, ICT systems.

5 Proposal on the Way Forward

- 5.1** The proposal is the mutual opt out of the Shared Internal Audit Services arrangement between Midlothian and Scottish Borders Councils at the end of 2021/22 and provide an appropriate period of notice to Scottish Borders Council. In addition, the proposal is for Midlothian Council to progress to a permanent Internal Audit staff resourcing arrangement to recruit a 1 FTE Chief Internal Auditor and 1 FTE AN Other Internal Auditor. This staff resourcing will replace the shared 0.5 FTE Chief Internal Auditor and 1.42 FTE Interim Specialist Auditor resource from Scottish Borders Council to provide greater certainty and allow for longer term planning of work and teams. It is important that Internal Audit FTE staffing levels are at least maintained at the current level albeit a proposed change in the mix and FTE of the relevant posts, to ensure delivery of the Internal Audit Annual Plans (2021/22 - 775 days) for Midlothian Council and MIJB.
- 5.2** The Corporate Management Team and Elected Members of Scottish Borders Council have been consulted on the evaluation conclusions and endorsed the mutual opt-out of the Shared Internal Audit Services arrangement between Midlothian and Scottish Borders Councils. This is of particular note due to the challenge of reduced capacity of the shared Chief Internal Auditor post impacting team management and development, in particular due to the change in the counter fraud and risk management support staff at Scottish Borders Council, from experienced and empowered post holders to a vacant post and new appointment. Furthermore, revisions to the Risk Management Policy and Strategy and the Counter Fraud Policy and Strategy of Scottish Borders Council for 2021-2024 have recently been approved; the implementation of which will be led by SBC's Chief Officer Audit & Risk (the shared Chief Internal Auditor).
- 5.3** The Corporate Management Team and the Audit Committee of Midlothian Council play an important role in ensuring that the Internal Audit function has sufficient staff resources with the appropriate skills and capabilities to ensure that its position and standing within the organisation is such that it can provide robust independent challenge to Senior Management and fulfil its statutory audit opinion requirement.
- 5.4** The Internal Audit Strategy and Plans set out the Internal Audit staff resources and activity to enable the Chief Internal Auditor to provide the statutory annual internal audit opinion regarding the adequacy and effectiveness of internal control within the organisations. The Internal Audit Strategy and Plans for 2022/23 that are in the initial stages of development will incorporate the proposed Internal Audit staff resources set out in this report.

6 Report Implications (Resource, Digital, Risk and Equalities)

6.1 Resource

Internal Audit reports directly to the Chief Executive (operationally) and the Audit Committee (functionally). There is currently a staff resource of 4.64 FTE for Internal Audit provision, comprising Chief Internal Auditor (0.5 FTE - shared with Scottish Borders Council), Interim Specialist Auditor resource (1.42 FTE - shared with Scottish Borders Council), Principal Internal Auditor (0.72 FTE), and Internal Auditor (2.0 FTE). Within the structure there are also 2 FTE Corporate Fraud Officers, who are line managed by the Principal Internal Auditor then to the Chief Internal Auditor, who are resources to support Management in tackling fraud, approved in August 2020 as part of the Council's Counter Fraud Policy and Strategy.

The proposal is to progress to a permanent arrangement to recruit 1 FTE Chief Internal Auditor and 1 FTE AN Other Internal Auditor. This Internal Audit staff resourcing will replace the shared 0.5 FTE Chief Internal Auditor and 1.42 FTE Interim Specialist Auditor resource from Scottish Borders Council. It is important that Internal Audit staffing levels are at least maintained at the current level albeit a proposed change in the mix and FTE of the relevant posts, to ensure delivery of the Internal Audit Annual Plans (2021/22 - 775 days) for Midlothian Council and MIJB. No changes are proposed within the rest of the structure. The proposals associated with this report are capable of being met from within existing budgets.

Midlothian Council's Internal Audit team provides assurance services to the Council and to the Midlothian Integration Joint Board, as part of the Council's commitment to partnership working.

6.2 Digital

There are no digital implications arising from this report.

6.3 Risk

It is important that Internal Audit staffing levels are at least maintained at the current level albeit a proposed change in the mix and FTE of the relevant posts. This is to ensure that a sufficient range and breadth of assurance audit work will be carried out each year to underpin the statutory Internal Audit opinion to Management and the Audit Committee on the effectiveness of internal controls and governance within the Council. The PSIAS require Internal Audit to evaluate the effectiveness of the Council's Risk Management arrangements and contribute to improvements in the process.

6.4 Ensuring Equalities

An Integrated Impact Assessment (IIA) will be carried out in advance to ensure not adverse impact on people (public or staff) or outcomes.

6.5 Additional Report Implications (See Appendix A)

APPENDIX A – Additional Report Implications

A.1 Key Priorities within the Single Midlothian Plan

Although this report does not relate directly to the key priorities within the Single Midlothian Plan to which Midlothian Council and its Community Planning Partners have made a commitment (Reducing the gap in economic circumstances; Reducing the gap in learning outcomes; Reducing the gap in health outcomes; and Reducing the impact of climate change), by providing an independent and objective annual assessment of the adequacy of the entire control environment, Internal Audit supports the Council to achieve its objectives.

A.2 Key Drivers for Change

Key drivers addressed in this report:

- ☒ Holistic Working
- ☒ Hub and Spoke
- ☒ Modern
- ☒ Sustainable
- ☒ Transformational
- ☒ Preventative
- ☒ Asset-based
- ☒ Continuous Improvement
- ☒ One size fits one
- ☐ None of the above

Midlothian Council is committed to creating a great place to grow supported by the 9 drivers for change. Implementing the 9 drivers for change in practice is applicable to the Council's Internal Audit service provision to assist the Council in achieving its objectives.

A.3 Key Delivery Streams

Key delivery streams addressed in this report:

- ☒ One Council Working with you, for you
- ☒ Preventative and Sustainable
- ☒ Efficient and Modern
- ☒ Innovative and Ambitious

A.4 Delivering Best Value

The definition of Internal Auditing within the Public Sector Internal Audit Standards (PSIAS) is "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes."

Implementation by Management of the actions associated with Internal Audit recommendations, that are designed to improve internal control

and governance arrangements and management of risks, underpins the Council's own continuous improvement arrangements to enhance its effectiveness, thus supporting the delivery of the Council's best value duties.

A.5 Involving Communities and Other Stakeholders

Internal Audit's purpose is to support the Council in its activities designed to achieve its declared objectives for the benefit of Midlothian's communities and other stakeholders.

The Chief Internal Auditor is accountable to the Audit Committee which, in fulfilling its governance role, acts as a bridge between the Council and other stakeholders.

A.6 Impact on Performance and Outcomes

The Findings and Recommendations from Internal Audit work during the year, which are designed to maintain and / or enhance internal controls, governance arrangements and risk management, assists the Council in improving its performance and outcomes.

A.7 Adopting a Preventative Approach

Having robust internal controls, governance arrangements and risk management in place contributes to safeguarding the Council's resources for delivery of services, as part of protecting the public purse. Internal Audit assurance and consultancy activity is designed to improve operations and assist the Council in accomplishing its objectives.

A.8 Supporting Sustainable Development

This report does not relate directly to supporting sustainable development. Good governance, including the provision of an Internal Audit service, is important to enable Midlothian Council to achieve its objectives.

Accounts Commission Report Community Empowerment: Covid-19 Update**Report by Chief Internal Auditor****Report for Noting****1 Recommendations**

The Audit Committee is asked to:

- a) Consider the Accounts Commission report Community Empowerment: Covid-19 Update; and
- b) Note that the Corporate Management Team on 12 January 2022 agreed to consider this report content in full to learn from good practice and new ways of working which emerged in response to Covid-19 and use this to shape their medium-term strategic plans and their approaches to supporting and empowering communities.

2 Purpose of Report/Executive Summary

The purpose of this report is to provide the Audit Committee with a summary of the Accounts Commission report, 'Community Empowerment – Covid-19 Update' published on 28 October 2021. The full report can be accessed on the Audit Scotland website using link below:

[Community empowerment: Covid-19 update | Audit Scotland \(audit-scotland.gov.uk\)](https://www.audit-scotland.gov.uk/community-empowerment-covid-19-update)

The Accounts Commission highlighted in its report that Communities played a crucial role in the response to Covid-19.

Purpose of the Accounts Commission report: Public bodies can learn from good practice and new ways of working which emerged in response to Covid-19 and use this to shape the way they work in the future to promote the best outcomes for local communities and help address inequalities. The report shares some of the many good examples of the community response to the pandemic and summarises the learning. It builds on the [Principles for community empowerment](#) published in 2019 and ongoing engagement with the Community Empowerment Advisory Group. Public bodies should use this information alongside their own learning to develop longer-term approaches to supporting and empowering communities.

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