Permitted Investments Appendix 1

The Council uses the Capita creditworthiness service. 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 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:-

Capita Colour Code	**Maximum Suggested Duration for Investment**
Yellow	6 years*
Dark Pink	6 years**
Light Pink	6 years**
Purple	3 years
Blue	2 years***
Orange	2 years
Red	7 months
Green	100 days
No colour	Not to be used

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

** *Dark Pink for Enhanced MMF's with a credit score of 1.25; Light Pink for Enhanced MMF's with a credit score of 1.5*

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

**** *The Green Limit was formerly for 3 months but the Financial Conduct Authority set (in July 2013) a requirement for qualifying deposits for bank liquidity buffers of a minimum of 95 days so the Green Limit has been slightly extended to accommodate this regulatory change*

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 7 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.

1.1 Deposits

Investment Category	Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period
Debt Management Agency Deposit Facility	--	Term	No	**100%**	**6 months**
Term deposits – local authorities	--	Term	No	**100%**	**2 years**
Call accounts – banks and building societies	Green	Instant	No	**100%**	**1 day**
Term deposits / Notice Accounts – banks and building societies	Yellow Purple Blue Orange Red Green No Colour	Term	No	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 7 mths** **Up to 100 days** **Not for use**
Fixed term deposits with variable rate and variable maturities: - Structured deposits	Yellow Purple Blue Orange Red Green No Colour	Term	No	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 7 mths** **Up to 100 days** **Not for use**

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

Investment Category	Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period
UK nationalised banks – Call accounts	Blue	Instant	No	**100%**	**1 day**
UK nationalised banks – Term Deposits / Notice Accounts	Blue	Term	No	**100%**	**2 years**
UK nationalised banks – Fixed term deposits with variable rate and variable maturities: - Structured deposits	Blue	Term	No	**100%**	**2 years**
Non-UK(high sovereign rated country) nationalised banks – Call accounts	Green	Instant	No	**100%**	**1 day**
Non-UK (high sovereign rated country) nationalised banks:- Term Deposits / Notice Accounts	Yellow Purple Blue Orange Red Green No Colour	Term	No	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 7 mths** **Up to 100 days** **Not for use**
Non-UK (high sovereign rated country) nationalised banks:- Fixed term deposits with variable rate and variable maturities: - Structured deposits	Yellow Purple Blue Orange Red Green No Colour	Term	No	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 7 mths** **Up to 100 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	AAA	Instant	No	**100%**	**1 day**
Enhanced Money Market Funds with a credit score of 1.25	AAA	T+1 to T+5	Yes	**100%**	**1 day**
Enhanced Money Market Funds with a credit score of 1.5	AAA	T+1 to T+5	Yes	**100%**	**1 day**
Bond Funds	AAA	T+2 or longer	Yes	**50%**	**1 day**
Gilt Funds	AAA	T+2 or longer	Yes	**50%**	**1 day**

1.4 Securities issued by corporate organisations

Investment Category	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Certificates of deposit issued by banks and building societies	Yellow Purple Blue Orange Red Green No Colour	Sale T+1	Yes	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 7 mths** **Up to 100 days** **Not for use**
Commercial paper other	Yellow Purple Blue Orange Red Green No Colour	Sale T+0	Yes	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 7 mths** **Up to 100 days** **Not for use**
Floating rate notes	Yellow Purple Blue Orange Red Green No Colour	Sale T+0	Yes	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 7 mths** **Up to 100 days** **Not for use**
Corporate Bonds other	Yellow Purple Blue Orange Red Green No Colour	Sale T+3	Yes	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 7 mths** **Up to 100 days** **Not for use**

1.5 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	**£1m**	**27 years**

Prudential Indicators Appendix 2

1. Prudential Indicators for Affordability

1.1 Estimates of Ratio of Financing Costs to Net Revenue Stream

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

Ratio of Financing Costs to Net Revenue Stream						
%	2013/14	2013/14	2014/15	2015/16	2016/17	2017/18
	Original	Actual	Estimate	Estimate	Estimate	Estimate
General Services	**4.19%**	**4.13%**	4.26%	3.86%	3.96%	4.06%
HRA	**32.75%**	**33.32%**	36.29%	36.37%	41.44%	42.13%

1.2 Estimates of the Incremental Impact of Investment Decisions on Council Tax and Rents

This indicator shows the change in Council Tax and Rents necessary to support increased spending on the capital account year on year. This is achieved by taking the difference between:-

- the capital plans used to calculate last years' prudential indicators; and
- the current capital plans.

The loan charges on that difference are then expressed as the change to Council Tax or Rents which would be necessary to support those charges.

Incremental Impact of Capital Investment Decisions on Council Tax and Housing Rent Levels						
	2013/14	2013/14	2014/15	2015/16	2016/17	2017/18
	Original	Actual	Estimate	Estimate	Estimate	Estimate
General Services	**£ (7.01)**	**£ (3.29)**	£ (6.43)	£ 7.95	£ 6.81	£ (1.31)
HRA	**£ (0.06)**	**£ (0.14)**	£ (0.38)	£ 0.32	£ 0.79	£ (0.00)

The figures in 1.1 and 1.2 above are based on the latest Capital Plans presented to Council.

2. Prudential Indicators for Capital Expenditure

2.1 Estimated Capital Expenditure

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

Capital Expenditure	2013/14 Actual £000's	2014/15 Estimate £000's	2015/16 Estimate £000's	2016/17 Estimate £000's	2017/18 Estimate £000's
General Services					
Resources	£ 7,232	£ 9,398	£ 8,614	£ 4,695	£ 5,145
Education, Community & Economy	£ 8,145	£ 4,918	£ 27,081	£ 13,843	£ 180
Health & Social Care	£ 995	£ 167	£ 457	£ 150	£ 150
Business Transformation	£ 970	£ 1,315	£ -	£ -	£ -
Total General Services	**£ 17,342**	**£ 15,798**	**£ 36,152**	**£ 18,688**	**£ 5,475**
Total HRA	**£ 16,104**	**£ 15,971**	**£ 39,587**	**£ 12,793**	**£ 12,874**
Combined Total	**£ 33,446**	**£ 31,769**	**£ 75,739**	**£ 31,481**	**£ 18,349**

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	2013/14 Actual £000's	2014/15 Estimate £000's	2015/16 Estimate £000's	2016/17 Estimate £000's	2017/18 Estimate £000's
Capital Expenditure					
General Services	£17,342	£15,798	£ 36,152	£18,688	£ 5,475
HRA	£16,104	£15,971	£ 39,587	£12,793	£12,874
Total	**£33,446**	**£31,769**	**£ 75,739**	**£31,481**	**£18,349**
Financed by:					
Capital receipts	£ 1,569	£ 1,955	£ 1,955	£ 1,955	£ 1,955
Capital grants	£ 7,318	£ 9,484	£ 9,537	£ 9,232	£ 9,227
Capital reserves	£ -	£ -	£ 6,000	£ -	£ -
Developer/Other Contributions	£ 2,326	£ 4,197	£ 10,943	£ 118	£ 121
Net financing need for the year	**£22,233**	**£16,133**	**£ 47,304**	**£20,176**	**£ 7,046**

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)					
	2013/14 Actual £000's	2014/15 Estimate £000's	2015/16 Estimate £000's	2016/17 Estimate £000's	2017/18 Estimate £000's
Capital Financing Requirement					
CFR – General Services	£ 107,615	£ 107,673	£ 114,084	£ 120,268	£ 113,215
CFR – HRA	£ 145,548	£ 154,561	£ 188,115	£ 194,001	£ 199,646
CFR – PFI Schemes	£ 58,340	£ 57,300	£ 56,180	£ 54,972	£ 53,659
Total CFR	**£ 311,503**	**£ 319,534**	**£ 358,379**	**£ 369,241**	**£ 366,520**
Movement in CFR	**£ 14,500**	**£ 8,031**	**£ 38,845**	**£ 10,862**	**£ (2,721)**
Movement in CFR represented by					
Net financing need for the year (previous table)	£ 22,233	£ 16,133	£ 47,304	£ 20,176	£ 7,046
Less Scheduled Debt Amortisation	£ 6,767	£ 7,062	£ 7,338	£ 8,106	£ 8,454
Less PFI Finance Lease Principal Payments	£ 966	£ 1,040	£ 1,120	£ 1,208	£ 1,313
Movement in CFR	**£ 14,500**	**£ 8,031**	**£ 38,846**	**£ 10,862**	**£ (2,721)**

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					
	2013/14 Actual £000's	2014/15 Estimate £000's	2015/16 Estimate £000's	2016/17 Estimate £000's	2017/18 Estimate £000's
External Debt					
Debt at 1 April	£ 230,020	£ 225,993	£ 253,209	£ 289,602	£ 300,709
Actual/Expected change in Debt	£ (4,027)	£ 27,216	£ 36,393	£ 11,107	£ (2,224)
Other long-term liabilities (OLTL)	£ 59,306	£ 58,340	£ 57,300	£ 56,180	£ 54,972
Actual/Expected change in OLTL	£ (966)	£ (1,040)	£ (1,120)	£ (1,208)	£ (1,313)
Actual/Expected Gross Debt at 31 March	**£ 284,333**	**£ 310,509**	**£ 345,782**	**£ 355,681**	**£ 352,144**
The Capital Financing Requirement	**£ 311,503**	**£ 319,534**	**£ 358,379**	**£ 369,241**	**£ 366,520**
Under / (over) borrowing	**£ 27,170**	**£ 9,025**	**£ 12,597**	**£ 13,560**	**£ 14,376**
Investments					
Cash & Cash Equivalents	£ 39,127	£ 5,000	£ 5,000	£ 5,000	£ 5,000
Short-Term Investments	£ -	£ 50,000	£ 50,000	£ 50,000	£ 50,000
Total Investments	**£ 39,127**	**£ 55,000**	**£ 55,000**	**£ 55,000**	**£ 55,000**

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 each of the next 3 financial years (2015/16 to 2017/18); 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				
	2014/15 Estimate £000's	2015/16 Estimate £000's	2016/17 Estimate £000's	2017/18 Estimate £000's
Operational Boundary - Borrowing	£262,234	£302,199	£314,269	£312,861
Operational Boundary - Other long term liabilities	£ 57,300	£ 56,180	£ 54,972	£ 53,659
Total	**£319,534**	**£358,379**	**£369,241**	**£366,520**

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 £314.3m by 31 March 2017. 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.

Council is therefore asked to approve that, rather than restrict borrowing to £262.2m for 2014/15, £302.2m for 2015/16, £314.3m for 2016/17 and £312.9m for 2017/18, that permission be granted to borrow up to the 2016/17 Authorised Limit for borrowing of £334.1m (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 2018 remains achievable.

Authorised Limit				
	2014/15	2015/16	2016/17	2017/18
	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's
Authorised Limit - Borrowing	£ 334,101	£ 334,101	£ 334,101	£ 334,101
Authorised Limit - Other long term liabilities	£ 57,300	£ 56,180	£ 54,972	£ 53,659
Total Debt	**£ 391,401**	**£ 390,281**	**£ 389,073**	**£ 387,760**

Reconciliation of calculation of Authorised Limit for borrowing:-

Reconciliation of Authorised Limit for Borrowing	
	£000's
CFR - General Services at 31 March 2017	£ 120,268
CFR - HRA at 31 March 2017	£ 194,001
Capital Receipts 2014/15 Unrealised to date	£ 598
Capital Receipts 2015/16-2017/18	£ 5,865
Developer/Other Contributions 2014/15 Unrealised to date	£ 2,187
Developer/Other Contributions 2015/16-2017/18	£ 11,182
Authorised Limit for Borrowing	**£ 334,101**

5. Prudential Indicators for Treasury Management

5.1 Adoption of the CIPFA Treasury Management Code of Practice

The adoption of CIPFA's *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes* is an indication of a clear, integrated and prudent approach to Treasury Management.

5.2 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 2015/16	
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%

5.3 Maturity Structure of Borrowing

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

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

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

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

Maturity Structure of Borrowing 2015/16		
Maturity structure of fixed interest rate borrowing 2015/16	**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 2015/16	**Lower**	**Upper**
Under 12 months	0.00%	30.00%
12 months to 2 years	0.00%	30.00%
2 years to 5 years	0.00%	30.00%
5 years to 10 years	0.00%	30.00%
10 years to 20 years	0.00%	30.00%
20 years to 30 years	0.00%	30.00%
30 years to 40 years	0.00%	30.00%
40 years to 50 years	0.00%	30.00%
50 years and above	0.00%	30.00%

5.4 Total Principal Sums Invested for Periods Longer than 364 Days

This indicator relates to the total level of investments held for periods longer than 364 days.

Principal Sums Invested for > 364 Days			
	2015/16	2016/17	2017/18
Limit	£50m	£50m	£50m

The current strategy as outlined in the body of these reports is to cash-back the Council's balance sheet reserves. It is expected that the majority of this will be in the form of 12 month fixed term deposits and/or certificates of deposit. The limit for prinicipal sums invested for > 364 days has been set at £50m to give the Council flexibility to extend the duration of such deposits on the margins, to e.g. 366 days or 13 months. As noted in the Investment Strategy section of this report, 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.

Appendix 3

Treasury Management & Annual Investment Strategy Statement

Midlothian Council
2015/16

INDEX

1 INTRODUCTION

1.1 Background

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

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

CIPFA defines treasury management as:

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

1.2 Reporting requirements

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

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

- the capital plans (including prudential indicators) for 15/16 to 17/18;
- the treasury management strategy (how the investments and borrowings are to be organised) for 15/16, including treasury indicators; and
- an investment strategy for 15/16 (the parameters on how investments are to be managed).

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

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

Scrutiny
The above reports are required to be adequately scrutinised before being recommended to the Council. This role is undertaken by the Audit Committee.

1.3 Treasury Management Strategy for 2015/16

The strategy for 2015/16 covers two main areas:

Capital issues

- the capital plans and the prudential indicators (Section 2 of this report).

Treasury management issues

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

These elements cover the requirements of the Local Government in Scotland Act 2003, the CIPFA Prudential Code, the CIPFA Treasury Management Code and Scottish Government Investment Regulations.

1.4 Training

The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsibe for scrutiny. A training workshop for Members was held on 14 June 2011 and further training will be arranged as required.

The training needs of treasury management officers are periodically reviewed.

1.5 Treasury management consultants

The Council uses Capita Asset Services as its external treasury management advisors.

The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

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

2 THE CAPITAL PRUDENTIAL INDICATORS 2015/16 – 2017/18

The Council's capital expenditure plans are the key driver of treasury management activity. The outputs of the capital expenditure plans are reflected in 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

	2013/14 Actual £000's	2014/15 Estimate £000's	2015/16 Estimate £000's	2016/17 Estimate £000's	2017/18 Estimate £000's
General Services					
Resources	£ 7,232	£ 9,398	£ 8,614	£ 4,695	£ 5,145
Education, Community & Economy	£ 8,145	£ 4,918	£ 27,081	£ 13,843	£ 180
Health & Social Care	£ 995	£ 167	£ 457	£ 150	£ 150
Business Transformation	£ 970	£ 1,315	£ -	£ -	£ -
Total General Services	**£ 17,342**	**£ 15,798**	**£ 36,152**	**£ 18,688**	**£ 5,475**
Total HRA	**£ 16,104**	**£ 15,971**	**£ 39,587**	**£ 12,793**	**£ 12,874**
Combined Total	**£ 33,446**	**£ 31,769**	**£ 75,739**	**£ 31,481**	**£ 18,349**

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

	2013/14 Actual £000's	2014/15 Estimate £000's	2015/16 Estimate £000's	2016/17 Estimate £000's	2017/18 Estimate £000's
Capital Expenditure					
General Services	£17,342	£15,798	£ 36,152	£18,688	£ 5,475
HRA	£16,104	£15,971	£ 39,587	£12,793	£12,874
Total	**£33,446**	**£31,769**	**£ 75,739**	**£31,481**	**£18,349**
Financed by:					
Capital receipts	£ 1,569	£ 1,955	£ 1,955	£ 1,955	£ 1,955
Capital grants	£ 7,318	£ 9,484	£ 9,537	£ 9,232	£ 9,227
Capital reserves	£ -	£ -	£ 6,000	£ -	£ -
Developer/Other Contributions	£ 2,326	£ 4,197	£ 10,943	£ 118	£ 121
Net financing need for the year	**£22,233**	**£16,133**	**£ 47,304**	**£20,176**	**£ 7,046**

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 scheduled debt amortisation (the principal repayment element of the loans fund charges) broadly reduces the borrowing need in line with each assets life.

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 £58.3m of such schemes within the CFR. The Council is asked to approve the CFR projections below:

Table 3: Capital Financing Requirement (CFR)

	2013/14	2014/15	2015/16	2016/17	2017/18
	Actual	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's
Capital Financing Requirement					
CFR – General Services	£ 107,615	£ 107,673	£ 114,084	£ 120,268	£ 113,215
CFR – HRA	£ 145,548	£ 154,561	£ 188,115	£ 194,001	£ 199,646
CFR – PFI Schemes	£ 58,340	£ 57,300	£ 56,180	£ 54,972	£ 53,659
Total CFR	**£ 311,503**	**£ 319,534**	**£ 358,379**	**£ 369,241**	**£ 366,520**
Movement in CFR	**£ 14,500**	**£ 8,031**	**£ 38,845**	**£ 10,862**	**£ (2,721)**
Movement in CFR represented by					
Net financing need for the year (previous table)	£ 22,233	£ 16,133	£ 47,304	£ 20,176	£ 7,046
Less Scheduled Debt Amortisation	£ 6,767	£ 7,062	£ 7,338	£ 8,106	£ 8,454
Less PFI Finance Lease Principal Payments	£ 966	£ 1,040	£ 1,120	£ 1,208	£ 1,313
Movement in CFR	**£ 14,500**	**£ 8,031**	**£ 38,846**	**£ 10,862**	**£ (2,721)**

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.

Table 4: Balance Sheet Resources

Reserve	2013/14	2014/15	2015/16	2016/17	2017/18
	Actual	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's
HRA Balances	£ 18,374	£ 21,284	£ 24,170	£ 25,096	£ 24,783
General Fund Balances	£ 11,964	£ 4,000	£ 4,000	£ 4,000	£ 4,000
Earmarked reserves	£ 8,547	£ 7,064	£ 7,064	£ 7,064	£ 7,064
Provisions	£ 2,553	£ 2,553	£ 2,553	£ 2,553	£ 2,553
Capital Fund	£ 10,658	£ 14,857	£ 15,507	£ 15,507	£ 16,601
Total Reserves / Core Funds	**£ 52,096**	**£ 49,758**	**£ 53,294**	**£ 54,220**	**£ 55,001**
Working capital*	£ 14,201	£ 14,267	£ 14,303	£ 14,340	£ 14,375
Under/over borrowing	£ 27,170	£ 9,025	£ 12,597	£ 13,560	£ 14,376
Expected investments	**£ 39,127**	**£ 55,000**	**£ 55,000**	**£ 55,000**	**£ 55,000**

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

2.4 Affordability prudential indicators

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

2.5 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						
%	2013/14	2013/14	2014/15	2015/16	2016/17	2017/18
	Original	Actual	Estimate	Estimate	Estimate	Estimate
General Services	**4.19%**	**4.13%**	4.26%	3.86%	3.96%	4.06%
HRA	**32.75%**	**33.32%**	36.29%	36.37%	41.44%	42.13%

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

2.6 Incremental impact of capital investment decisions on council tax and housing rent levels

These indicators identify the revenue costs associated with proposed changes to the three year capital programme recommended in current budget reports compared to the Council's existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates, such as the level of Government support, which are not published over a three year period.

Table 6: Incremental Impact of Capital Investment Decisions on Council Tax and Housing Rent Levels						
	2013/14	2013/14	2014/15	2015/16	2016/17	2017/18
	Original	Actual	Estimate	Estimate	Estimate	Estimate
General Services	**£ (7.01)**	**£ (3.29)**	£ (6.43)	£ 7.95	£ 6.81	£ (1.31)
HRA	**£ (0.06)**	**£ (0.14)**	£ (0.38)	£ 0.32	£ 0.79	£ (0.00)

2.7 HRA ratios

Table 7: HRA Debt as a % of Gross Revenue					
	2013/14	2014/15	2015/16	2016/17	2017/18
	Actual	Estimate	Estimate	Estimate	Estimate
HRA debt £000's	£ 145,548	£ 154,559	£ 188,111	£ 193,999	£ 199,649
HRA revenues £000's	£ 22,156	£ 23,225	£ 25,350	£ 26,725	£ 28,048
Ratio of debt to revenues %	657%	665%	742%	726%	712%

Table 8: HRA Debt per Dwelling					
	2013/14	2014/15	2015/16	2016/17	2017/18
	Actual	Estimate	Estimate	Estimate	Estimate
HRA debt £000's	£ 145,548	£ 154,559	£ 188,111	£ 193,999	£ 199,649
Number of HRA dwellings	6,850	6,891	7,015	7,096	7,151
Debt per dwelling £	£ 21,248	£ 22,429	£ 26,816	£ 27,339	£ 27,919

3 Borrowing

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

3.1 Current portfolio position

The Council's treasury portfolio position at 31 March 2014, with forward projections are summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

Table 9: Current Treasury Portfolio

	2013/14 Actual £000's	2014/15 Estimate £000's	2015/16 Estimate £000's	2016/17 Estimate £000's	2017/18 Estimate £000's
External Debt					
Debt at 1 April	£ 230,020	£ 225,993	£ 253,209	£ 289,602	£ 300,709
Actual/Expected change in Debt	£ (4,027)	£ 27,216	£ 36,393	£ 11,107	£ (2,224)
Other long-term liabilities (OLTL) at 1 April	£ 59,306	£ 58,340	£ 57,300	£ 56,180	£ 54,972
Actual/Expected change in OLTL	£ (966)	£ (1,040)	£ (1,120)	£ (1,208)	£ (1,313)
Actual/Expected Gross Debt at 31 March	**£ 284,333**	**£ 310,509**	**£ 345,782**	**£ 355,681**	**£ 352,144**
The Capital Financing Requirement	**£ 311,503**	**£ 319,534**	**£ 358,379**	**£ 369,241**	**£ 366,520**
Under / (over) borrowing	**£ 27,170**	**£ 9,025**	**£ 12,597**	**£ 13,560**	**£ 14,376**
Investments					
Cash & Cash Equivalents	£ 39,127	£ 5,000	£ 5,000	£ 5,000	£ 5,000
Short-Term Investments	£ -	£ 50,000	£ 50,000	£ 50,000	£ 50,000
Total Investments	**£ 39,127**	**£ 55,000**	**£ 55,000**	**£ 55,000**	**£ 55,000**

Within the prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2015/16 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

The Head of Finance & Integrated Service Support reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

3.2 Treasury Indicators: limits to borrowing activity

The operational boundary

This is the limit beyond which external debt is not normally expected to exceed. 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 maximum value of the CFR over the next 3 financial years (2015/16 to 2017/18); 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 10: Operational Boundary

	2014/15 Estimate £000's	2015/16 Estimate £000's	2016/17 Estimate £000's	2017/18 Estimate £000's
Operational Boundary - Borrowing	£262,234	£302,199	£314,269	£312,861
Operational Boundary - Other long term liabilities	£ 57,300	£ 56,180	£ 54,972	£ 53,659
Total	**£319,534**	**£358,379**	**£369,241**	**£366,520**

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 3 financial years (2015/16 to 2017/18), 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 £262.2m in 2014/15, £302.2m in 2015/16, £314.3m in 2016/17 and £312.9m in 2017/18, that permission be granted to borrow up to the 2016/17 authorised limit for borrowing of £334.1m (as shown in the table below), if market conditions supported this action;
    b. This would have the effect of securing lower costs for future years but care would be taken to ensure that the cost of carry from borrowing early is minimized and that the maturity structure of all debt is sufficiently robust to ensure that the CFR at 31 March 2018 remains achievable.
    c. The authorised limit therefore reflects a level of borrowing which, while not desired, could be afforded but is not sustainable.
3. The Authorised Limit for Other Long-Term Liabilities has been calculated to equate directly to the Operational Boundary for Other Long-Term Liabilities,

given the known contractual provisions for the repayment of debt within the Council's two PPP agreements.

Table 11: Authorised Limit				
	2014/15 Estimate £000's	2015/16 Estimate £000's	2016/17 Estimate £000's	2017/18 Estimate £000's
Authorised Limit - Borrowing	£ 334,101	£ 334,101	£ 334,101	£ 334,101
Authorised Limit - Other long term liabilities	£ 57,300	£ 56,180	£ 54,972	£ 53,659
Total Debt	**£ 391,401**	**£ 390,281**	**£ 389,073**	**£ 387,760**

Table 12: Reconciliation of Authorised Limit for Borrowing	
	£000's
CFR - General Services at 31 March 2017	£ 120,268
CFR - HRA at 31 March 2017	£ 194,001
Capital Receipts 2014/15 Unrealised to date	£ 598
Capital Receipts 2015/16-2017/18	£ 5,865
Developer/Other Contributions 2014/15 Unrealised to date	£ 2,187
Developer/Other Contributions 2015/16-2017/18	£ 11,182
Authorised Limit for Borrowing	**£ 334,101**

3.3 Prospects for interest rates

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

Table 13: Interest Rate Forecasts Quarterly Averages				
Quarter Ending	Bank Rate	PWLB Borrowing Rates (inc. certainty rate adjustment)		
		5 year	25 year	50 year
Now	0.50%	1.81%	3.03%	3.02%
Mar 2015	0.50%	2.20%	3.40%	3.40%
Jun 2015	0.50%	2.20%	3.50%	3.50%
Sep 2015	0.50%	2.30%	3.70%	3.70%
Dec 2015	0.75%	2.50%	3.80%	3.80%
Mar 2016	0.75%	2.60%	4.00%	4.00%
Jun 2016	1.00%	2.80%	4.20%	4.20%
Sep 2016	1.00%	2.90%	4.30%	4.30%
Dec 2016	1.25%	3.00%	4.40%	4.40%
Mar 2017	1.25%	3.20%	4.50%	4.50%
Jun 2017	1.50%	3.30%	4.60%	4.60%
Sep 2017	1.75%	3.40%	4.70%	4.70%
Dec 2017	1.75%	3.50%	4.70%	4.70%
Mar 2018	2.00%	3.60%	4.80%	4.80%

UK GDP growth surged during 2013 and the first half of 2014. Since then it appears to have subsided somewhat but still remains strong by UK standards and is expected to continue likewise into 2015 and 2016. There needs to be a significant rebalancing of the economy away from consumer spending to manufacturing, business investment and exporting in order for this recovery to become more firmly established. One drag on the economy has been that wage inflation has only recently started to exceed CPI inflation, so enabling disposable income and living standards to start improving. The plunge in the price of oil brought CPI inflation down to a low of 1.0% in November, the lowest rate since September 2002. Inflation is expected to stay around or below 1.0% for the best part of a year; this will help improve consumer disposable income and so underpin economic growth during 2015. However, labour productivity needs to improve substantially to enable wage rates to increase and further support consumer disposable income and economic growth. In addition, the encouraging rate at which unemployment has been falling must eventually feed through into pressure for wage increases, though current views on the amount of hidden slack in the labour market probably means that this is unlikely to happen early in 2015.

The US, the biggest world economy, has generated stunning growth rates of 4.6% (annualised) in Q2 2014 and 5.0% in Q3. This is hugely promising for the outlook for strong growth going forwards and it very much looks as if the US is now firmly on the path of full recovery from the financial crisis of 2008. Consequently, it is now confidently expected that the US will be the first major western economy to start on central rate increases by mid 2015.

The current economic outlook and structure of market interest rates and government debt yields have several key treasury management implications:

- Greece: the general election on 25 January 2015 is likely to bring a political party to power which is anti EU and anti austerity. However, if this eventually results in Greece leaving the Euro, it is unlikely that this will directly destabilise the

Eurozone as the EU has put in place adequate firewalls to contain the immediate fallout to just Greece. However, the indirect effects of the likely strenthening of anti EU and anti austerity political parties throughout the EU is much more difficult to quantify;

- As for the Eurozone in general, concerns in respect of a major crisis subsided considerably in 2013. However, the downturn in growth and inflation during the second half of 2014, and worries over the Ukraine situation, Middle East and Ebola, have led to a resurgence of those concerns as risks increase that it could be heading into deflation and prolonged very weak growth. Sovereign debt difficulties have not gone away and major concerns could return in respect of individual countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise to levels that could result in a loss of investor confidence in the financial viability of such countries. Counterparty risks therefore remain elevated. This continues to suggest the use of higher quality counterparties for shorter time periods;
- Investment returns are likely to remain relatively low during 2015/16 and beyond;
- Borrowing interest rates have been volatile during 2014 as alternating bouts of good and bad news have promoted optimism, and then pessimism, in financial markets. The closing weeks of 2014 saw gilt yields dip to historically remarkably low levels after inflation plunged, a flight to quality from equities (especially in the oil sector), and from the debt and equities of oil producing emerging market countries, and an increase in the likelihood that the ECB will commence quantitative easing (purchase of EZ government debt) in early 2015. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in later times, when authorities will not be able to avoid new borrowing to finance new capital expenditure and/or to refinance maturing debt;
- There will remain a cost of carry to any new borrowing which causes an increase in investments as this will incur a revenue loss between borrowing costs and investment returns.

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

3.4 Borrowing strategy

The Council is expected to have an under-borrowed (internally-borrowed) position of c. £9.0m by the end of financial year 2014/15. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is relatively high.

Against this backdrop and the risks within the economic forecast, caution will be adopted with the 2015/16 treasury operations. The Head of Finance & Integrated Service Support will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

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

- *if it was felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast,* perhaps arising from a faster than currently anticipated unwinding of quantitative easing in the US, or an unexpected increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates are still lower than they will be in the next few years.

It is expected that throughout the majority of 2015/16, temporary borrowing from the money markets or other local authorities will remain at historically low levels of below bank base rate (i.e. sub-0.50%), whilst new long term PWLB borrowing sits at somewhere between 2.7%-4.5%. If rates remain at these levels, utilisation of temporary borrowing within the Council's overall loan portfolio would continue to provide the most cost-effective solution to the Council.

However, this will be viewed against the backdrop of potential long term costs if the opportunity is missed to take PWLB loans at historically low medium-long term rates, particularly given the projected gradual rise in PWLB rates.

Treasury management limits on activity

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

- Upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates for borrowing based upon the gross debt position, and variable interest rates for investments based upon the total investment position;

- Upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates for both borrowing and investments;

- Maturity structure of borrowing. These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

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

Table 14: Treasury Indicators & Limits			
	2015/16	2016/17	2017/18
Interest rate exposures	**Upper**	**Upper**	**Upper**
Limits on fixed interest rates based on gross debt	100.00%	100.00%	100.00%
Limits on variable interest rates based on gross debt	30.00%	30.00%	30.00%
Limits on fixed interest rates based on investments	100.00%	100.00%	100.00%
Limits on variable interest rates based on investments	100.00%	100.00%	100.00%
Maturity structure of fixed interest rate borrowing 2015/16		**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 2015/16		**Lower**	**Upper**
Under 12 months		0.00%	30.00%
12 months to 2 years		0.00%	30.00%
2 years to 5 years		0.00%	30.00%
5 years to 10 years		0.00%	30.00%
10 years to 20 years		0.00%	30.00%
20 years to 30 years		0.00%	30.00%
30 years to 40 years		0.00%	30.00%
40 years to 50 years		0.00%	30.00%
50 years and above		0.00%	30.00%

3.5 Policy on borrowing in advance of need

The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sum borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates (as detailed in Section 3.2) and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

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

3.6 Debt rescheduling

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

The reasons for any rescheduling to take place will include:

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

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

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

4 ANNUAL INVESTMENT STRATEGY

4.1 Changes to the Credit Rating methodology

The main rating agencies (Fitch, Moody's and Standard & Poor's) have, through much of the financial crisis, provided some institutions with a ratings "uplift" due to implied levels of sovereign support. More recently, in response to the evolving regulatory regime, the agencies have indicated they may remove these "uplifts". This process has commenced at the start of February, and as such this means immediate changes to the credit methodology are required.

It is important to stress that the rating agency changes do not reflect any changes in the underlying status of the institution or credit environment, merely the implied level of sovereign support that has been built into ratings through the financial crisis. The eventual removal of implied sovereign support will only take place when the regulatory and economic environments have ensured that financial institutions are much stronger and less prone to failure in a financial crisis.

Both Fitch and Moody's provide "standalone" credit ratings for financial institutions. For Fitch, it is the Viability Rating, while Moody's has the Financial Strength Rating. Due to the future removal of sovereign support from institution assessments, both agencies have suggested going forward that these will be in line with their respective Long Term ratings. As such, there is no point monitoring both Long Term and these "standalone" ratings.

Furthermore, Fitch has already begun assessing its Support ratings, with a clear expectation that these will be lowered to 5, which is defined as "A bank for which there is a possibility of external support, but it cannot be relied upon." With all institutions likely to drop to these levels, there is little to no differentiation to be had by assessing Support ratings.

As a result of these rating agency changes, the credit element of Capita's future methodology will focus solely on the Short and Long Term ratings of an institution. Rating Watch and Outlook information will continue to be assessed where it relates to these categories. This is the same process for Standard & Poor's that Capita have always taken, but a change to the use of Fitch and Moody's ratings. Furthermore, Capita will continue to utilise CDS prices as an overlay to ratings in their new methodology.

4.2 Investment policy

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

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

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

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

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

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

4.3 Creditworthiness policy

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

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

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

Table 15: Recommended Maximum Durations for Investments	
Sector Colour Code	**Maximum Suggested Duration for Investment**
Yellow	6 years*
Dark Pink	6 years**
Light Pink	6 years**
Purple	3 years
Blue	2 years***
Orange	2 years***
Red	7 months
Green	100 days****
No colour	Not to be used

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

** *Dark Pink for Enhanced MMF's with a credit score of 1.25*
Light Pink for Enhanced MMF's with a credit score of 1.5

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

**** *The Green Limit was formerly for 3 months but the Financial Conduct Authority set (in July 2013) a requirement for qualifying deposits for bank liquidity buffers of a minimum of 95 days so the Green Limit has been slightly extended to accommodate this regulatory change*

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

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

- if a downgrade results in the counterparty / investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately;
- in addition to the use of credit ratings the Council will be advised of information in movements in credit default swap spreads against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

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

4.4 Country limits

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

The list of countries that qualify using the above criteria as at the date of this report are shown in Appendix 5.5. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

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

Officers will continually monitor and review the level of shareholding in the UK Government backed banks throughout the remainder of 2014/15 and the course of 2015/16, and whether the £30 million counterparty limit for both banks remains robust.

4.5 Investment strategy

In-house funds. Investments will be made with reference to the core balance and cash flow requirements and the outlook for short- to medium-term interest rates (i.e. rates for investments up to 12 months).

Investment returns expectations. Bank Rate is forecast to remain unchanged at 0.50% before starting to rise from quarter 4 of 2015. Bank Rate forecasts for financial year ends (March) are:-

- 2014/15 0.50%
- 2015/16 0.75%
- 2016/17 1.25%
- 2016/17 2.00%

There are downside risks to these forecasts (i.e. start of increases in Bank Rate occurs later) if economic growth weakens. However, should the pace of growth quicken, there could be upside risk.

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

2015/16	0.60%
2016/17	1.25%
2017/18	1.75%

Investment treasury indicator and limit - total principal funds invested for greater than 364 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

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

Table 16: Principal Sums Invested for > 364 Days			
	2015/16	2016/17	2017/18
Limit	£50m	£50m	£50m

The current strategy as outlined in the body of these reports is to cash-back the Council's balance sheet reserves. It is expected that the majority of this will be in the form of 12 month fixed term deposits and/or certificates of deposit. The limit for prinicipal sums invested for > 364 days has been set at £50m to give the Council flexibility to extend the duration of such deposits on the margins, to e.g. 366 days or 13 months. As noted in Section 4.3, a thorough appraisal of the additional risk involved in extending the duration of any deposit (marginally) beyond the maximum suggested by Capita, against any enhanced value to the portfolio, will be undertaken prior to the placement of any deposit.

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

4.6 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.

4.7 Procedures for reviewing the holding of longer-term investments

The TM Code requires that, where authorities hold longer term investments, that these are periodically reviewed. It is proposed that this is carried out semi-annually, as part of the Treasury Management Outturn and Half-yearly update reports, to ensure that the Council's policy objectives continue to be met and that the risk exposure to the Council continues to be mitigated as far as is reasonably possible.

5 Appendices

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

5.1 APPENDIX: Economic Background

UK. After strong UK GDP growth in 2013 at an annual rate of 2.7%, and then in 2014 0.7% in Q1, 0.9% in Q2 2014 (annual rate 3.2% in Q2), Q3 has seen growth fall back to 0.7% in the quarter and to an annual rate of 2.6%. It therefore appears that growth has eased since the surge in the first half of 2014 leading to a downward revision of forecasts for 2015 and 2016, albeit that growth will still remain strong by UK standards. For this recovery to become more balanced and sustainable in the longer term, the recovery needs to move away from dependence on consumer expenditure and the housing market to exporting, and particularly of manufactured goods, both of which need to substantially improve on their recent lacklustre performance. This overall strong growth has resulted in unemployment falling much faster than expected. The MPC is now focusing on how quickly slack in the economy is being used up. It is also particularly concerned that the squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back significantly above the level of inflation in order to ensure that the recovery will be sustainable. There also needs to be a major improvement in labour productivity, which has languished at dismal levels since 2008, to support increases in pay rates. Unemployment is expected to keep on its downward trend and this is likely to eventually feed through into a return to significant increases in wage growth at some point during the next three years. However, just how much those future increases in pay rates will counteract the depressive effect of increases in Bank Rate on consumer confidence, the rate of growth in consumer expenditure and the buoyancy of the housing market, are areas that will need to be kept under regular review.

Also encouraging has been the sharp fall in inflation (CPI), reaching 1.0% in November 2014, the lowest rate since September 2002. Forward indications are that inflation is likely to remain around or under 1% for the best part of a year. The return to strong growth has helped lower forecasts for the increase in Government debt over the last year but monthly public sector deficit figures during 2014 have disappointed until November. The autumn statement, therefore, had to revise the speed with which the deficit is forecast to be eliminated.

Eurozone (EZ). The Eurozone is facing an increasing threat from weak or negative growth and from deflation. In November 2014, the inflation rate fell further, to reach a low of 0.3%. However, this is an average for all EZ countries and includes some countries with negative rates of inflation. Accordingly, the ECB took some rather limited action in June and September 2014 to loosen monetary policy in order to promote growth. It now appears likely that the ECB will embark on full quantitative easing (purchase of EZ country sovereign debt) in early 2015.

Concern in financial markets for the Eurozone subsided considerably after the prolonged crisis during 2011-2013. However, sovereign debt difficulties have not gone away and major issues could return in respect of any countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy, (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise for some countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed. The ECB's pledge in 2012 to buy unlimited amounts of bonds of countries which ask for a bailout has provided heavily indebted countries with a strong defence against market forces. This has bought them time to make progress with their economies to return to growth or to reduce the degree of recession. However, debt to GDP ratios (2013 figures) of Greece 180%, Italy 133%, Portugal 129%, Ireland 124% and Cyprus 112%, remain a cause of concern, especially as some of these countries are experiencing continuing rates of increase in debt in excess of their rate of economic growth i.e. these debt ratios are likely to continue to deteriorate. Any sharp downturn in economic growth would make these countries particularly vulnerable to a new bout of sovereign debt crisis. It should also be noted that Italy has the third biggest debt mountain in the world behind Japan and the US.

Greece: the general election due to take place on 25 January 2015 is likely to bring a political party to power which is anti EU and anti austerity. However, if this eventually results in Greece leaving the Euro, it is unlikely that this will directly destabilise the Eurozone as the EU has put in place adequate firewalls to contain the immediate fallout to just Greece. However, the indirect effects of the likely strenthening of anti EU and anti austerity political parties throughout the EU is much more difficult to quantify. There are particular concerns as to whether democratically elected governments will lose the support of electorates suffering under EZ imposed austerity programmes, especially in countries which have high unemployment rates. There are also major concerns as to whether the governments of France and Italy will effectively implement austerity programmes and undertake overdue reforms to improve national competitiveness. These countries already have political parties with major electoral support for anti EU and anti austerity policies. Any loss of market confidence in either of the two largest Eurozone economies after Germany would present a huge challenge to the resources of the ECB to defend their debt.

USA. The U.S. Federal Reserve ended its monthly asset purchases in October 2014. GDP growth rates (annualised) for Q2 and Q3 of 4.6% and 5.0% have been stunning and hold great promise for strong growth going forward. It is therefore confidently forecast that the first increase in the Fed. rate will occur by the middle of 2015.

China. Government action in 2014 to stimulate the economy appeared to be putting the target of 7.5% growth within achievable reach but recent data has indicated a marginally lower outturn for 2014, which would be the lowest rate of growth for many years. There are also concerns that the Chinese leadership has only started to address an unbalanced economy which is heavily over dependent on new investment expenditure, and for a potential bubble in the property sector to burst, as it did in Japan in the 1990s, with its consequent impact on the financial health of the banking sector. There are also concerns around the potential size, and dubious creditworthiness, of some bank lending to local government organisations and major corporates. This primarily occurred during the government promoted expansion of credit, which was aimed at protecting the overall rate of growth in the economy after the Lehmans crisis.

Japan. Japan is causing considerable concern as the increase in sales tax in April 2014 has suppressed consumer expenditure and growth to the extent that it has slipped back into recession in Q2 and Q3. The Japanese government already has the highest debt to GDP ratio in the world.

CAPITA ASSET SERVICES FORWARD VIEW

Economic forecasting remains difficult with so many external influences weighing on the UK. Our Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data transpires over 2015. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, or the safe haven of bonds.

The overall longer run trend is for gilt yields and PWLB rates to rise, due to the high volume of gilt issuance in the UK, and of bond issuance in other major western countries. Increasing investor confidence in eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.

The overall balance of risks to economic recovery in the UK is currently evenly balanced. Only time will tell just how long this current period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

The interest rate forecasts in this report are based on an initial assumption that there will not be a major resurgence of the EZ debt crisis. There is an increased risk that Greece could end up leaving the Euro but if this happens, the EZ now has sufficient fire walls in place that a Greek exit would have little immediate direct impact on the rest of the EZ and the Euro. It is therefore expected that there will be an overall managed, albeit painful and tortuous, resolution of any EZ debt crisis that may occur where EZ institutions and governments eventually do what is necessary - but only when all else has been tried and failed. Under this assumed scenario, growth within the EZ will be weak at best for the next couple of years with some EZ countries experiencing low or negative growth, which will, over that time period, see an increase in total government debt to GDP ratios. There is a significant danger that these ratios could rise to the point where markets lose confidence in the financial viability of one, or more, countries, especially if growth disappoints and / or efforts to reduce government deficits fail to deliver the necessary reductions. However, it is impossible to forecast whether any individual country will lose such confidence, or when, and so precipitate a sharp resurgence of the EZ debt crisis. While the ECB has adequate resources to manage a debt crisis in a small EZ country, if one, or more, of the larger countries were to experience a major crisis of market confidence, this would present a serious challenge to the ECB and to EZ politicians.

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

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
- UK strong economic growth is weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU, US and China.
- A resurgence of the Eurozone sovereign debt crisis.
- Recapitalisation of European banks requiring more government financial support.
- Monetary policy action failing to stimulate sustainable growth and to combat the threat of deflation in western economies, especially the Eurozone and Japan.

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

- An adverse reaction by financial markets to the result of the UK general election in May 2015 and the economic and debt management policies adopted by the new government
- ECB either failing to carry through on recent statements that it will soon start quantitative easing (purchase of government debt) or severely disappointing financial markets with embarking on only a token programme of minimal purchases which are unlikely to have much impact, if any, on stimulating growth in the EZ.
- The commencement by the US Federal Reserve of increases in the central rate in 2015 causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities, leading to a sudden flight from bonds to equities.
- A surge in investor confidence that a return to robust world economic growth is imminent, causing a flow of funds out of bonds into equities.
- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

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 a very high 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 'liquidity risk' will show each investment instrument as being:-

    a. **Instant Access** (money returned same day);
    b. **Notice T+3** = transaction date plus 3 business days before you get cash; or
    c. **Term** i.e. money is locked in until an agreed maturity date.

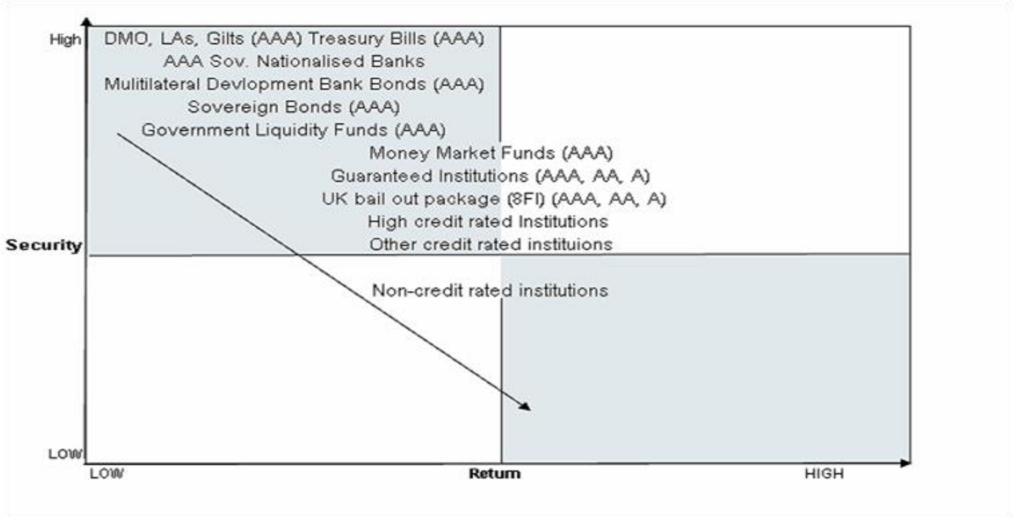
3. **Market risk:** this is the risk that, through adverse market fluctuations in the value of the principal sums an organisation borrows and invests, its stated treasury management policies and objectives are compromised, against which effects it has failed to protect itself adequately. However, some 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.

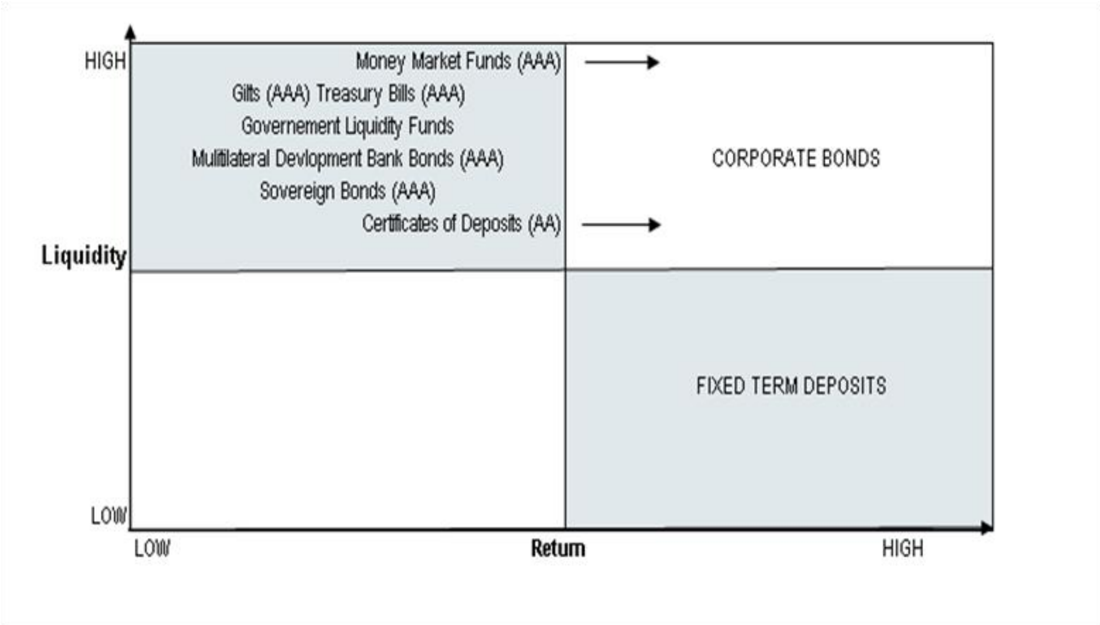
The graph below summarises the risk exposure of various types of investment instrument. It shows that as you move from top to bottom, so the level of credit risk increases. However, moving from top to bottom also results in moving towards the right i.e. returns increase. The overall message is: -

- low risk = low rate of return
- higher risk = higher rate of return



The next graph shows the other message: -

- high liquidity = low return
- low liquidity = higher returns



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 high creditworthiness to enable investments to be made safely. 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.

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 at a time when many authorities are disappointed at the failure in 2008 of credit ratings to protect investors from the Icelandic bank failures and are both cautious about other forms of investing and are prepared to bear the loss of income to the treasury management budget compared to earnings levels in previous years. The longest term deposit that can be made with the DMADF is 6 months.

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

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

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

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

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.

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

a. **Government liquidity funds.** These are very similar to money market funds (see below) but only invest in government debt issuance with highly rated governments. They offer a lower rate of return than MMFs but slightly higher than the returns from the DMADF.

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 risk appetite 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. They also offer a constant Net Asset Value (NAV) i.e. the principal sum invested has high security.

c. **Enhanced Money Market 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 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.

5. 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 would involve the Council subscribing subordinated debt to the SPV that is set up to deliver the Newbattle Centre project (2 year construction and 25 year operational contract length). The expected length of the investment would be 24-24.5 years (assuming the subscription is made at operation commencement of the contract), or 26-26.5 years if the subscription is made during the construction phase. The repayment profile of the subscription is still to be agreed, but would typically comprise 75% of the principal remaining invested until the final years of the contract. The risk associated with this type of investment will be mitigated through a thorough annual assessment as a minimum to review the holding of such debt, and whether the exposure to risk arising from the investment has changed over the period.

Table 1: Permitted Investments

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

1.1 Deposits

Investment Category	Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period
Debt Management Agency Deposit Facility	--	Term	No	**100%**	**6 months**
Term deposits – local authorities	--	Term	No	**100%**	**2 years**
Call accounts – banks and building societies	Green	Instant	No	**100%**	**1 day**
Term deposits / Notice Accounts – banks and building societies	Yellow Purple Blue Orange Red Green No Colour	Term	No	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 7 mths** **Up to 100 days** **Not for use**
Fixed term deposits with variable rate and variable maturities: - Structured deposits	Yellow Purple Blue Orange Red Green No Colour	Term	No	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 7 mths** **Up to 100 days** **Not for use**

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

Investment Category	Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period
UK nationalised banks – Call accounts	Blue	Instant	No	**100%**	**1 day**
UK nationalised banks – Term Deposits / Notice Accounts	Blue	Term	No	**100%**	**2 years**
UK nationalised banks – Fixed term deposits with variable rate and variable maturities: - Structured deposits	Blue	Term	No	**100%**	**2 years**
Non-UK(high sovereign rated country) nationalised banks – Call accounts	Green	Instant	No	**100%**	**1 day**
Non-UK (high sovereign rated country) nationalised banks:- Term Deposits / Notice Accounts	Yellow Purple Blue Orange Red Green No Colour	Term	No	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 7 mths** **Up to 100 days** **Not for use**
Non-UK (high sovereign rated country) nationalised banks:- Fixed term deposits with variable rate and variable maturities: - Structured deposits	Yellow Purple Blue Orange Red Green No Colour	Term	No	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 7 mths** **Up to 100 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	AAA	Instant	No	**100%**	**1 day**
Enhanced Money Market Funds with a credit score of 1.25	AAA	T+1 to T+5	Yes	**100%**	**1 day**
Enhanced Money Market 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 by corporate organisations

Investment Category	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Certificates of deposit issued by banks and building societies	Yellow Purple Blue Orange Red Green No Colour	Sale T+1	Yes	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 7 mths** **Up to 100 days** **Not for use**
Commercial paper other	Yellow Purple Blue Orange Red Green No Colour	Sale T+0	Yes	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 7 mths** **Up to 100 days** **Not for use**
Floating rate notes	Yellow Purple Blue Orange Red Green No Colour	Sale T+0	Yes	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 7 mths** **Up to 100 days** **Not for use**
Corporate Bonds other	Yellow Purple Blue Orange Red Green No Colour	Sale T+3	Yes	**100%**	**Up to 6 yrs** **Up to 3 yrs** **Up to 2 yrs** **Up to 2 yrs** **Up to 7 mths** **Up to 100 days** **Not for use**

1.5 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	**£1m**	**27 years**

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

Midlothian Council Permitted Investments, Associated Controls and Limits

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

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

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits
g. 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 Capita Asset Services overlaid. Day to day investment dealing for this criterion will be further strengthened by the use of additional market intelligence.	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, with the credit scoring methodology by Capita Asset Services overlaid. Day to day investment dealing for this criterion will be further strengthened by the use of additional market intelligence.	As shown in Appendix 5.2.

i. Corporate bonds **(Medium to high risk depending on period & credit rating)**	These are marketable securities issued by financial and corporate institutions. Counterparty risk will vary and there is risk to value of capital loss arising from selling ahead of maturity if combined with an adverse movement in interest rates. Liquidity risk will be low.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's, with the credit scoring methodology by Capita Asset Services overlaid. Corporate bonds will be restricted to those meeting the base criteria. Day to day investment dealing for this criterion will be further strengthened by the use of additional market intelligence.	As shown in Appendix 5.2.
Other types of investments			
j. Loans to third parties	Using the example of a loan to a RSL, these would be medium risk investments, exhibiting higher risks than categories (a)-(f) above. They are also highly illiquid and are only repaid at the end of a defined period of time (up to 20 years) or on the sale of a property, whichever is the earlier.	The risk associated with such an investment would be mitigated through the application of a premium on the loan rate. The Council will also request that a standard security is taken over the property which would allow the Council to require the sale of the homes to another landlord, providing greater risk mitigation.	£25m
k. 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
l. Local Authority Mortgage	These are service investments at market rates		As shown in

Scheme (LAMS)	of interest plus a premium.		Appendix 5.2.
m. Subordinated Debt Subscription to Newbattle Centre SPV	These are investments that are exposed to the success or failure of individual projects and are highly illiquid.	The Council and Scottish Government (via the SFT) are participants in and party to the governance and controls within the project structure. As such they are well placed to influence and ensure the successful completion of the project's term.	As shown in Appendix 5.2.

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

5.4 APPENDIX: Approved countries for investments

Based on the lowest available rating.

AAA

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

AA+

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

AA

- Abu Dhabi (UAE)
- France
- Qatar

AA-

- Belgium
- Saudi Arabia

5.5 APPENDIX: Treasury management scheme of delegation

(i) Full Council

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

(iii) Audit Committee

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

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

The S95 (responsible) officer

- recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance;
- submitting regular treasury management policy reports;
- submitting budgets and budget variations;
- receiving and reviewing management information reports;
- reviewing the performance of the treasury management function;
- ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function;
- ensuring the adequacy of internal audit, and liaising with external audit;
- recommending the appointment of external service providers.