Appendix 4

Treasury Management Strategy Statement
and Annual Investment Strategy

Midlothian Council
2022/23

INDEX

1 INTRODUCTION

1.1 Background

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

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

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

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

CIPFA defines treasury management as:

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

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

1.2 Reporting requirements

1.2.1 Capital Strategy

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

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

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

1.2.2 Treasury Management Reporting

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

a) **Prudential and treasury indicators and treasury strategy** (this report) - The first, and most important report covers:
   - the capital plans (including prudential indicators) for 2021/22 to 2025/26;
   - a policy for the statutory repayment of debt, (how residual capital expenditure is charged to revenue over time);
   - the treasury management strategy (how the investments and borrowings are to be organised) for 2022/23, including treasury indicators; and
   - a permitted investment strategy for 2022/23 (the parameters on how investments are to be managed).

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

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

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

1.3 Treasury Management Strategy for 2022/23

The strategy for 2022/23 covers two main areas:

Capital issues

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

Treasury management issues

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

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

1.4 Training

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

A training workshop in Treasury Management for the Financial Services team, led by the Council's Treasury Management consultants Link Group, Treasury Solutions, took place on 3 March 2016.

1.5 Treasury management consultants

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

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

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

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

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

2.1 Capital expenditure

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

The table below summarises the Capital Expenditure forecasts:-

Table 1: Capital Expenditure

	2020/21 Actual £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's	2025/26 Estimate £000's
General Services						
Place	£ 14,709	£ 14,901	£ 34,115	£ 23,718	£ 16,322	£ 9,529
People & Partnerships	£ 10,780	£ 10,489	£ 33,760	£ 35,853	£ 32,560	£ 10,747
Council Transformation	£ 69	£ 776	£ 1,019	£ 7,421	£ 11,725	£ 1,039
Provision for Return of Contingencies	£ -	£ (639)	£ (654)	£ (1,722)	£ (1,675)	£ (1,515)
Total General Services	**£ 25,558**	**£ 25,527**	**£ 68,240**	**£ 65,270**	**£ 58,933**	**£ 19,799**
Total HRA	**£ 15,632**	**£ 45,559**	**£ 124,894**	**£ 56,651**	**£ 14,858**	**£ 10,114**
Combined Total	**£ 41,190**	**£ 71,086**	**£ 193,134**	**£ 121,920**	**£ 73,790**	**£ 29,913**

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

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

Table 2: Capital Expenditure and Available Financing

	2020/21 Actual £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's	2025/26 Estimate £000's
Capital Expenditure						
General Services	£ 25,558	£ 25,527	£ 68,240	£ 65,270	£ 58,933	£ 19,799
HRA	£ 15,632	£ 45,559	£ 124,894	£ 56,651	£ 14,858	£ 10,114
Total	**£ 41,190**	**£ 71,086**	**£ 193,134**	**£ 121,920**	**£ 73,790**	**£ 29,913**
Financed by:						
Capital receipts	£ 998	£ 72	£ -	£ -	£ -	£ -
Capital grants	£ 20,194	£ 15,907	£ 22,214	£ 28,277	£ 11,937	£ 8,186
Capital reserves	£ -	£ 27,000	£ 3,000	£ 2,533	£ 7,694	£ -
Developer/Other Contributions	£ 3,661	£ 3,143	£ 14,822	£ 8,402	£ 8,363	£ 5,566
Net financing need for the year	**£ 16,337**	**£ 24,963**	**£ 153,098**	**£ 82,709**	**£ 45,797**	**£ 16,161**

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

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

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

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

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

Table 3: Capital Financing Requirement (CFR)

	2020/21 Actual £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's	2025/26 Estimate £000's
Capital Financing Requirement						
CFR – General Services	£ 119,929	£ 130,387	£ 166,151	£ 202,023	£ 234,144	**£ 237,587**
CFR – HRA	£ 172,394	£ 182,419	£ 294,230	£ 335,663	£ 342,248	**£ 343,999**
CFR – PFI Schemes	£ 99,203	£ 95,914	£ 92,433	£ 88,739	£ 84,815	£ 80,661
Total CFR	**£ 391,526**	**£ 408,720**	**£ 552,814**	**£ 626,425**	**£ 661,207**	**£ 662,247**
Movement in CFR	**£ (2,376)**	**£ 17,194**	**£ 144,094**	**£ 73,611**	**£ 34,782**	**£ 1,040**
Movement in CFR represented by						
Net financing need for the year (previous table)	£ 16,337	£ 24,963	£ 153,098	£ 82,709	£ 45,797	£ 16,161
Less Scheduled Debt Amortisation	£ (8,170)	£ (5,670)	£ (5,843)	£ (10,214)	£ (10,961)	£ (10,967)
Less net PFI Finance Lease Principal Payments	£ (10,543)	£ (3,289)	£ (3,481)	£ (3,694)	£ (3,924)	£ (4,154)
Movement in CFR	**£ (2,376)**	**£ 16,004**	**£ 143,774**	**£ 68,801**	**£ 30,912**	**£ 1,040**

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

2.3 Core funds and expected investment balances

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

Table 4: Balance Sheet Resources

Reserve	2020/21 Actual £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's	2025/26 Estimate £000's
HRA Balances	£ 48,385	£ 28,763	£ 26,823	£ 22,197	£ 23,538	£ 24,307
General Fund Balances	£ 3,812	£ 3,812	£ 3,650	£ 3,650	£ 3,650	£ 3,650
Earmarked reserves	£ 25,859	£ 12,930	£ -	£ -	£ -	£ -
Provisions	£ 3,897	£ 3,236	£ 3,214	£ 2,787	£ 2,600	£ 2,500
Capital Fund	£ 24,158	£ 23,703	£ 20,703	£ 18,170	£ 10,476	£ 8,607
Total Reserves / Core Funds	**£ 106,111**	**£ 72,444**	**£ 54,390**	**£ 46,804**	**£ 40,264**	**£ 39,064**
Working capital*	£ 42,689	£ 51,913	£ 25,610	£ 23,196	£ 24,736	£ 25,936
Under/over borrowing	£ 17,528	£ (10,644)	£ -	£ -	£ -	£ -
Expected investments	**£ 131,272**	**£ 135,000**	**£ 80,000**	**£ 70,000**	**£ 65,000**	**£ 65,000**

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

2.3 Statutory repayment of loans fund advances

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

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

New Assets

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

Prudent Repayment of Loans Fund Advances

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

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

Table 5: Asset Classes to adopt the "Asset Life" method

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

** Average loans fund advance length*

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

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

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

3 Borrowing

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

3.1 Treasury management portfolio position

The overall treasury management portfolio as at 31 March 2021 and for the position as at 27 January 2022 are shown below for both borrowing and investments.

Table 6: Portfolio Position 31 March 2021 and 27 January 2022

Loan Type	31 March 2021		27 January 2022	
	Principal Outstanding £000's	Weighted Average Rate	Principal Outstanding £000's	Weighted Average Rate
PWLB Annuity	597	8.90%	553	8.90%
PWLB Maturity	235,424	3.28%	284,776	2.70%
LOBO	20,000	4.51%	20,000	4.51%
Market Loans	18,191	2.68%	17,721	2.68%
Salix Loans	583	0.00%	400	0.00%
Total Loans	**274,795**	**3.34%**	**323,450**	**2.81%**

Deposit Type	31 March 2021		27 January 2022	
	Principal Outstanding £000's	Weighted Average Rate	Principal Outstanding £000's	Weighted Average Rate
Bank Call Accounts	26,470	0.01%	29,914	0.16%
Money Market Funds	29,817	0.01%	21,637	0.10%
Bank Notice Accounts	14,985	0.58%	14,985	0.58%
Bank Fixed Term Deposits	-	n/a	35,000	0.41%
Other Local Authorities	60,000	1.62%	60,000	1.62%
Total Deposits	**131,272**	**0.81%**	**161,536**	**0.79%**

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

Table 7: Net Borrowing Requirement	2020/21 Actual £000's	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's	2025/26 Estimate £000's
External Debt						
Debt at 1 April	£ 269,077	£ 274,795	£ 323,450	£ 460,382	£ 537,686	£ 576,392
Actual/Expected change in Debt	£ 5,718	£ 48,655	£ 136,932	£ 77,305	£ 38,706	£ 5,194
Other long-term liabilities (OLTL) at 1 April	£ 109,746	£ 99,203	£ 95,914	£ 92,433	£ 88,739	£ 84,815
Actual/Expected change in OLTL	£ (10,543)	£ (3,289)	£ (3,481)	£ (3,694)	£ (3,924)	£ (4,154)
Actual/Expected Gross Debt at 31 March	**£ 373,998**	**£ 419,364**	**£ 552,815**	**£ 626,425**	**£ 661,207**	**£ 662,247**
The Capital Financing Requirement	**£ 391,526**	**£ 408,720**	**£ 552,814**	**£ 626,425**	**£ 661,207**	**£ 662,247**
Under / (over) borrowing	**£ 17,528**	**£ (10,644)**	**£ -**	**£ -**	**£ -**	**£ -**
Deposits						
Cash & Cash Equivalents	£ 56,287	£ 65,000	£ 25,000	£ 25,000	£ 25,000	£ 25,000
Short-Term Investments	£ 74,985	£ 70,000	£ 55,000	£ 45,000	£ 40,000	£ 40,000
Total Deposits	**£ 131,272**	**£ 135,000**	**£ 80,000**	**£ 70,000**	**£ 65,000**	**£ 65,000**

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

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

3.2 Treasury Indicators: limits to borrowing activity

The operational boundary

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

For this Council:-

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

Table 8: Operational Boundary

	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's	2025/26 Estimate £000's
Operational Boundary - Borrowing	£ 312,806	£ 460,381	£ 537,686	£ 576,392	£ 581,586
Operational Boundary - Other long term liabilities	£ 95,914	£ 92,433	£ 88,739	£ 84,815	£ 80,661
Total	**£ 408,720**	**£ 552,814**	**£ 626,425**	**£ 661,207**	**£ 662,247**

The authorised limit for external debt

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

1. This is the statutory limit (Affordable Capital Expenditure Limit) determined under section 35 (1) of the Local Government in Scotland Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised;
2. The Authorised Limit for Borrowing has been calculated by taking the maximum value of the CFR over the next 4 financial years (2022/23 to 2025/26), with the total forecast level of capital receipts and developer contributions ***added back*** to this figure (given the inherent uncertainty regarding the timing and value of these receipts/contributions):-
    a. Council is therefore asked to approve that, rather than restrict borrowing to £312.806 million for 2021/22, £460.381 million for 2022/23, £537.686 million for 2023/24, £576.392 million for 2024/25, and £581.586 million for 2025/26, that permission be granted to borrow up to the 2025/26 Authorised Limit for Borrowing of £621.955 million as shown in the table below), if market conditions support this action;
    b. Should market conditions support any borrowing in advance of need, any borrowing drawn would be supported by a business case which will appraise the anticipated savings in borrowing costs (from expected increases in rates later in the year / in forthcoming years) against the carrying cost associated with borrowing in advance of need
    c. This would have the effect of securing lower costs for future years but care would be taken to ensure that the cost of carry from borrowing early is minimized and that the maturity structure of all debt is sufficiently robust to ensure that the CFR at 31 March 2026 remains achievable.

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

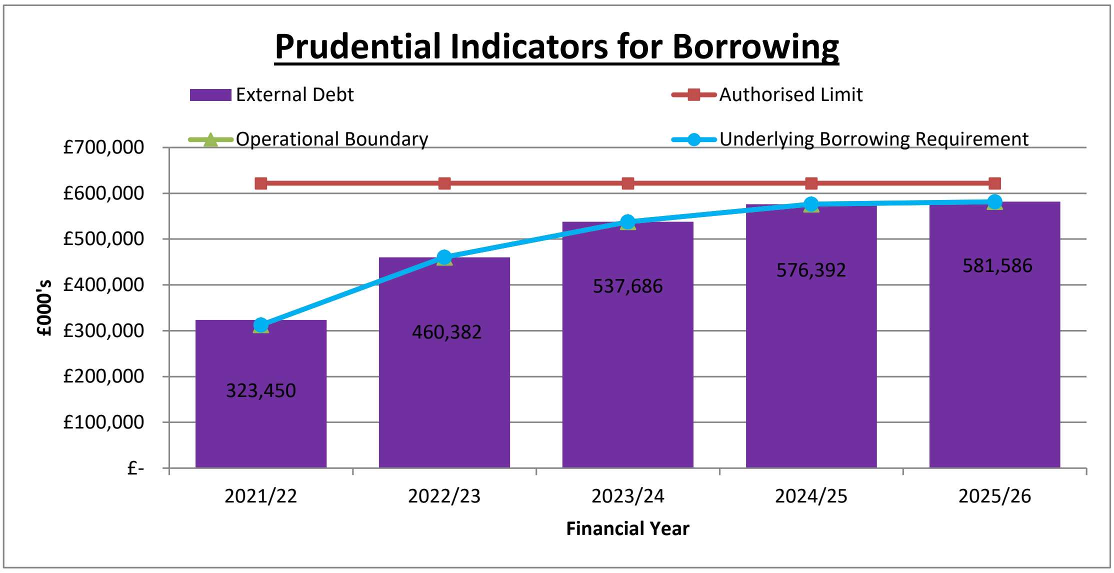
3. The Authorised Limit for Other Long-Term Liabilities has been calculated to equate directly to the Operational Boundary for Other Long-Term Liabilities, given the known contractual provisions for the repayment of debt within the Council's four DBFM agreements.

Table 9: Authorised Limit

	2021/22 Estimate £000's	2022/23 Estimate £000's	2023/24 Estimate £000's	2024/25 Estimate £000's	2025/26 Estimate £000's
Authorised Limit - Borrowing	£ 312,806	£ 460,381	£ 537,686	£ 576,392	£ 581,586
Authorised Limit - Other long term liabilities	£ 95,914	£ 92,433	£ 88,739	£ 84,815	£ 80,661
Total Debt	**£ 408,720**	**£ 552,814**	**£ 626,425**	**£ 661,207**	**£ 662,247**

Table 10: Reconciliation of Authorised Limit for Borrowing

	£000's
CFR - General Services at 31 March 2026	£ 237,587
CFR - HRA at 31 March 2026	£ 343,999
Capital Receipts 21/22 to 25/26 unrealised to date	£ 72
Developer/Other Contributions 21/22 to 25/26 unrealised to date	£ 40,297
Authorised Limit for Borrowing	**£ 621,955**



3.3 Prospects for interest rates

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

Link Group Interest Rate View 20.12.21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25
BANK RATE	0.25	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25
3 month ave earnings	0.30	0.50	0.50	0.60	0.70	0.80	0.90	0.90	1.00	1.00	1.00	1.00	1.00
6 month ave earnings	0.50	0.60	0.60	0.70	0.80	0.90	1.00	1.00	1.10	1.10	1.10	1.10	1.10
12 month ave earnings	0.70	0.70	0.70	0.80	0.90	1.00	1.10	1.10	1.20	1.20	1.20	1.20	1.20
5 yr PWLB	1.50	1.50	1.60	1.60	1.70	1.80	1.80	1.80	1.90	1.90	1.90	2.00	2.00
10 yr PWLB	1.70	1.80	1.80	1.90	1.90	2.00	2.00	2.00	2.10	2.10	2.10	2.20	2.30
25 yr PWLB	1.90	2.00	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.40	2.40	2.50	2.50
50 yr PWLB	1.70	1.80	1.90	1.90	2.00	2.00	2.00	2.10	2.10	2.20	2.20	2.30	2.30
Bank Rate													
Link	0.25	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25
Capital Economics	0.50	0.75	1.00	1.25	1.25	1.25	1.25	1.25	-	-	-	-	-
5yr PWLB Rate													
Link	1.50	1.50	1.60	1.60	1.70	1.80	1.80	1.80	1.90	1.90	1.90	2.00	2.00
Capital Economics	1.80	1.90	2.10	2.20	2.20	2.30	2.40	2.40	-	-	-	-	-
10yr PWLB Rate													
Link	1.70	1.80	1.80	1.90	1.90	2.00	2.00	2.00	2.10	2.10	2.10	2.20	2.30
Capital Economics	2.00	2.10	2.20	2.30	2.30	2.40	2.50	2.50	-	-	-	-	-
25yr PWLB Rate													
Link	1.90	2.00	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.40	2.40	2.50	2.50
Capital Economics	2.20	2.30	2.50	2.70	2.70	2.70	2.80	2.90	-	-	-	-	-
50yr PWLB Rate													
Link	1.70	1.80	1.90	1.90	2.00	2.00	2.00	2.10	2.10	2.20	2.20	2.30	2.30
Capital Economics	1.90	2.00	2.20	2.40	2.50	2.60	2.70	2.90	-	-	-	-	-

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

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

Significant risks to the forecasts:-

- **Mutations** of the virus render current vaccines ineffective, and tweaked vaccines to combat these mutations are delayed, or cannot be administered fast enough to prevent further lockdowns. 25% of the population not being vaccinated is also a significant risk to the NHS being overwhelmed and lockdowns being the only remaining option.
- **Labour and supply shortages** prove more enduring and disruptive and depress economic activity.
- **The Monetary Policy Committee** acts too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- **The Monetary Policy Committee** tightens monetary policy too late to ward off building inflationary pressures.
- **The Government** acts too quickly to cut expenditure to balance the national budget.
- **UK / EU trade arrangements** – if there was a major impact on trade flows and financial services due to complications or lack of co-operation in sorting out significant remaining issues.

- **Longer term US treasury yields** rise strongly and pull gilt yields up higher than forecast.
- **Major stock markets** e.g., in the US, become increasingly judged as being over-valued and susceptible to major price corrections. Central banks become increasingly exposed to the “moral hazard” risks of having to buy shares and corporate bonds to reduce the impact of major financial market selloffs on the general economy.
- **Geopolitical risks**, for example in Ukraine, Iran, North Korea, but also in Europe and Middle Eastern countries; on-going global power influence struggles between Russia/China/US. These could lead to increasing safe-haven flows.

The balance of risks to the UK economy:-

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

Forecasts for Bank Rate

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

- We do not know how severe an impact Omicron could have on the economy and whether there will be another lockdown or similar and, if there is, whether there would be significant fiscal support from the Government for businesses and jobs.
- There were already increasing grounds for viewing the economic recovery as running out of steam during the autumn and now into the winter. And then along came Omicron to pose a significant downside threat to economic activity. This could lead into stagflation, or even into recession, which would then pose a dilemma for the MPC as to whether to focus on combating inflation or supporting economic growth through keeping interest rates low.
- Will some current key supply shortages spill over into causing economic activity in some sectors to take a significant hit?
- Rising gas and electricity prices in October and next April and increases in other prices caused by supply shortages and increases in taxation next April, are already going to deflate consumer spending power without the MPC having to take any action on Bank Rate to cool inflation.
- On the other hand, consumers are sitting on over £160bn of excess savings left over from the pandemic so when will they spend this sum, in part or in total?
- It looks as if the economy coped well with the end of furlough on 30th September. It is estimated that there were around 1 million people who came off furlough then and there was not a huge spike up in unemployment. The other side of the coin is that vacancies have been hitting record levels so there is a continuing acute shortage of workers. This is a potential danger area if this shortage drives up wages which then feed through into producer prices and the prices of services i.e., a second-round effect that the MPC would have to act against if it looked like gaining significant momentum.
- We also recognise there could be further nasty surprises on the Covid front beyond the Omicron mutation.

- If the UK invokes article 16 of the Brexit deal over the dislocation in trading arrangements with Northern Ireland, this has the potential to end up in a no-deal Brexit.

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

It should also be borne in mind that Bank Rate being cut to 0.25% and then to 0.10%, were emergency measures to deal with the Covid crisis hitting the UK in March 2020. At any time, the MPC could decide to simply take away such emergency cuts on no other grounds than they are no longer warranted, and as a step forward in the return to normalisation. In addition, any Bank Rate under 1% is both highly unusual and highly supportive of economic growth.

Forecasts for PWLB rates and gilt and treasury yields

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

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

US treasury yields

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

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

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

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

There are also possible **DOWNSIDE RISKS** from the huge sums of cash that the UK populace have saved during the pandemic; when savings accounts earn little interest, it is likely that some of this cash mountain could end up being invested in bonds and so push up demand for bonds and support their prices i.e., this would help to keep their yields down. How this will interplay with the Bank of England eventually getting round to not reinvesting maturing gilts and then later selling gilts, will be interesting to monitor.

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

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

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

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

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

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

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

One of the key results of the pandemic has been a fundamental rethinking and shift in monetary policy by major central banks like the Fed, the Bank of England and the ECB, to tolerate a higher level of inflation than in the previous two decades when inflation was the prime target to bear down on so as to stop it going above a target rate. There is now also a greater emphasis on other targets for monetary policy than just inflation, especially on 'achieving broad and inclusive "maximum" employment in its entirety' in the US, before consideration would be given to increasing rates.

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

Deposit and borrowing rates

- **Deposit returns** are expected to improve in 2022/23. However, while markets are pricing in a series of Bank Rate hikes, actual economic circumstances may see the MPC fall short of these elevated expectations.
- **Borrowing interest rates** fell to historically very low rates as a result of the COVID crisis and the quantitative easing operations of the Bank of England and still remain at historically low levels. The policy of avoiding new borrowing by running down spare cash balances has served local authorities well over the last few years.
- On 25.11.20, the Chancellor announced the conclusion to the review of margins over gilt yields for PWLB rates which had been increased by 100 bps in October 2019. The standard and certainty margins were reduced by 100 bps but a prohibition was introduced to deny access to borrowing from the PWLB for any local authority which had purchase of assets for yield in its three-year capital programme. The current margins over gilt yields are as follows: -
    - **PWLB Standard Rate** is gilt plus 100 basis points (G+100bps)
    - **PWLB Certainty Rate** is gilt plus 80 basis points (G+80bps)
    - **PWLB HRA Standard Rate** is gilt plus 100 basis points (G+100bps)
    - **PWLB HRA Certainty Rate** is gilt plus 80bps (G+80bps)
    - **Local Infrastructure Rate** is gilt plus 60bps (G+60bps)

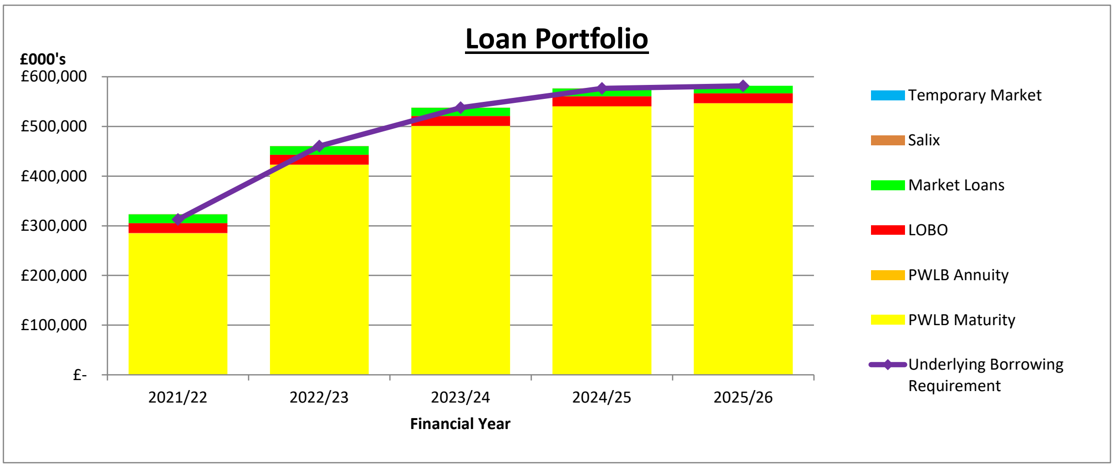
- **Borrowing for capital expenditure**. Link Group's long-term (beyond 10 years), forecast for Bank Rate is 2.00%. As some PWLB certainty rates are currently below 2.00%, there remains value in considering long-term borrowing from the PWLB where appropriate. Temporary borrowing rates are likely, however, to remain near Bank Rate and may also prove attractive as part of a balanced debt portfolio. Other forward borrowing opportunities, which largely avoid a cost of carry, will continue to be explored.
- Given the continued uncertainty in the market there may be further opportunities for further long term borrowing to be undertaken in financial year 2021/22 and into early 2022/23 to fund the Council's £251 million medium term borrowing requirement as outlined in Table 3 of the covering report. Any borrowing drawn would be supported by a business case which will appraise the anticipated savings in borrowing costs (from expected increases in rates later in the year / in forthcoming years) against the carrying cost associated with borrowing in advance of need.

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

3.4 Borrowing strategy

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

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



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

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

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

Quarter 2 of 2022 (to 0.50%) Quarter 1 of 2023 (to 0.75%), Quarter 1 of 2024 (to 1.00%) and finally, Quarter 1 of 2025, which would take the base rate to 1.25%.

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

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

Given the potential for uncertainty in the market to bring a dip in gilt yields and therefore PWLB rates, there may be further opportunities for further long term borrowing to be undertaken in financial year 2021/22 and into early 2022/23 to fund the Council's £246 million remaining medium term borrowing requirement to 2025/26 as outlined in Table 4 above. Any further borrowing drawn would be supported by a business case which will appraise the anticipated savings in borrowing costs (from expected increases in rates later in the year / in forthcoming years) against the carrying cost associated with borrowing in advance of need.

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

Treasury management limits on activity

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

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

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

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

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

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

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

4 ANNUAL INVESTMENT STRATEGY

4.1 Investment policy

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

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

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

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

1. The Council applies **minimum acceptable credit criteria** in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the short-term and long-term ratings.

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

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

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

5. **Lending limits**, (maturity tenors), for each counterparty will be set through applying the matrix table in Section 4.2 (maturity durations).

6. Investments will only placed with counterparties from countries with a specified minimum **sovereign rating**, (see paragraph 4.3).

7. Lending per **Country** and **Institution** will be set through the application of the criteria in Section 4.3 (amounts).

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

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

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

11. All investments will be denominated in sterling.

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

4.2 Creditworthiness policy

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

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

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

Table 14: Recommended Maximum Durations for Investments	
Link Asset Services Colour Code	**Maximum Suggested Duration for Investment**
Yellow	6 years*
Dark Pink	6 years**
Light Pink	6 years**
Purple	2.5 years
Blue	1.25 years***
Orange	1.25 years
Red	7 months
Green	120 days
No colour	Not to be used

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

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

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

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

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

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

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

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

All credit ratings will be monitored weekly. The Council is alerted to changes to ratings of all three agencies through its use of the Link Group, Treasury Solutions creditworthiness service.

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

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

UK banks – ring fencing

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

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

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

4.3 Country and sector limits

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

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

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

4.4 Investment strategy

Current Deposits

As at 27 January 2022, the Council's deposits were as follows:-

Counterparty	Amount £000's	Security *Long/Short Term Rating* (Colour)***	Liquidity	Yield	UK Local Authority Investment*** £000's
MMF Aberdeen	14,910	AAAmmf *(Yellow)*	Instant Access	0.10%	1,316,048
MMF Federated	6,659	AAAmmf *(Yellow)*	Instant Access	0.10$	1,035,348
MMF LGIM	69	AAAmmf *(Yellow)*	Instant Access	0.05%	129,103
Bank of Scotland Call Account	29,900	A+/F1 (Red)	Instant Access	0.16%	454,127
Royal Bank of Scotland Call Account	13	A+/F1 *(Blue)*	Instant Access	0.01%	180,570
Svenska Handelsbanken AB Call Account	1	AA/F1+ *(Orange)*	Instant Access	0.05%	721,491
Santander	14,985	A+/F1 (*Red*)	180 day notice account	0.58%	648,018
Goldman Sachs International Bank	15,000	A+/F1 (Red)	Start: 17 Dec 2021 End: 17 Jun 2022	0.47%	1,095,653
Standard Chartered Bank	15,000	A+/F1 (Red)	Start: 17 Dec 2021 End: 17 Jun 2022	0.39%	640,018
National Bank of Canada	5,000	A+/F1 (Orange)	Start: 17 Dec 2021 End: 17 Jun 2022	0.32%	95,000
Wokingham Borough Council	15,000	Quasi-UK Government (AA- / *Yellow*)	Start: 25 Mar 2020 End: 24 Mar 2023	1.60%	3,315,722
Medway Council	15,000	Quasi-UK Government (AA- / *Yellow*)	Start: 30 Mar 2020 End: 30 Mar 2022	1.80%	
London Borough of Croydon	13,000	Quasi-UK Government (AA- / *Yellow*)	Start: 03 Apr 2020 End: 03 Oct 2022	1.85%	
Stoke on Trent City Council	2,000	Quasi-UK Government (AA- / *Yellow*)	Start: 06 Apr 2020 End: 06 Apr 2023	1.60%	
London Borough of Waltham Forest	15,000	Quasi-UK Government (AA- / *Yellow*)	Start: 06 Apr 2020 End: 06 Apr 2023	1.25%	
Total	**165,130**				**9,631,098**

** Credit Rating from Fitch*
*** Colour represents maximum recommended duration for investment per Link Group, Treasury Solutions, Treasury Solutions Credit Scoring methodology – see Appendix 2.*
**** As at 31 October 2021*

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

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

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

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

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

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

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

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

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

4.5 Investment risk benchmarking

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

4.6 End of year investment report

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

5 Appendices

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

5.1 APPENDIX: Economic Background

COVID-19 vaccines.

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

A SUMMARY OVERVIEW OF THE FUTURE PATH OF BANK RATE

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

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

MPC MEETING 16TH DECEMBER 2021

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

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

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

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

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

US.

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

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

EU.

- The slow role out of vaccines initially delayed economic recovery in early 2021 but the vaccination rate then picked up sharply. After a contraction of -0.3% in Q1, Q2 came in with strong growth of 2%. With Q3 at 2.2%, the EU recovery was then within 0.5% of its pre Covid size. However, the arrival of Omicron is now a major headwind to growth in quarter 4 and the expected downturn into weak growth could well turn negative, with the outlook for the first two months of 2022 expected to continue to be very weak.

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

CHINA.

- After a concerted effort to get on top of the virus outbreak in Q1 2020, economic recovery was strong in the rest of **2020**; this enabled China to recover all the initial contraction. During 2020, policy makers both quashed the virus and implemented a programme of monetary and fiscal support that was particularly effective at stimulating short-term growth. At the same time, China's economy benefited from the shift towards online spending by consumers in developed markets. These factors helped to explain its comparative outperformance compared to western economies during 2020 and earlier in 2021.

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

JAPAN.

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

WORLD GROWTH.

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

SUPPLY SHORTAGES.

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

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

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

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

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

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

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

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

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

Controls on treasury risks

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

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

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

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

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

Unlimited investments

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

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

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

Objectives of each type of investment instrument

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

1. DEPOSITS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

4. SECURITIES ISSUED OR GUARANTEED BY GOVERNMENTS

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

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

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

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

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

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

5. SECURITIES ISSUED BY CORPORATE ORGANISATIONS

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

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

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

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

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

6. OTHER

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

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

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

d. **ESCO:** Midlothian Energy Limited (MEL) Joint Venture between Midlothian Council and Vattenfall to deliver energy supply to Shawfair using heat supplied from the Millerhill Energy from Waste plant and related projects.

Table 1: Permitted Investments

1.1 Deposits

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

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

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

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

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

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

1.4 Securities issued or guaranteed by governments

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

1.5 Securities issued by corporate organisations

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

1.6 Other

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

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

Midlothian Council Permitted Investments, Associated Controls and Limits

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

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

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

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

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

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

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

5.4 APPENDIX: Approved countries for investments

Based on the lowest available rating as at 27.01.2022

AAA

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

AA+

- Canada
- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)
- France

AA-

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

5.5 APPENDIX: Treasury management scheme of delegation

(i) Full Council

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

(iii) Audit Committee

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

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

The S95 (responsible) officer

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

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