

Notice of Meeting and Agenda



Audit Committee

Venue: Council Chambers,
Midlothian House, Dalkeith, EH22 1DN

Date: Tuesday, 29 January 2019

Time: 11:00

Director, Resources

Contact:

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Further Information:

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

Recording Notice: Please note that this meeting will be recorded. The recording will be publicly available following the meeting. The Council will comply with its statutory obligations under the Data Protection Act 1998 and the Freedom of Information (Scotland) Act 2002.

1 Welcome, Introductions and Apologies

2 Order of Business

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

3 Declaration of Interest

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

4 Minute of Previous Meeting

4.1 Minute of Meeting of 11 December 2018 submitted for approval 3 - 12

4.2 Action Log updated 13 - 14

5 Public Reports

5.1 Audit Scotland Report Local government in Scotland Financial Overview 2017-18 - Report by Head of Finance and Integrated Service Support 15 - 20

5.2 Final Internal Audit Report - Payroll - Report by Chief Internal Auditor 21 - 28

5.3 Follow-up report on Outstanding actions by Chief Internal Auditor 29 - 40

5.4 Final Internal Audit Report on Revenue Budget Monitoring - Report by Chief Internal Auditor (to follow)

5.5 Final Internal Audit Report on Delivering Excellence Programme - Report by Chief Internal Auditor (to follow)

5.6 Treasury Management and Investment Strategy 2019-20 - Report by Head of Finance and Integrated Service Support 41 - 112

6 Private Reports

No items for discussion

7 Date of Next Meeting

The next meeting will be held on 12 March 2019 at 10.00 am

Minute of Meeting

Audit Committee
Tuesday 29 January 2019
Item No: 4.1



Audit Committee

Date	Time	Venue
Tuesday 11 December 2018	11.00 am	Council Chambers, Midlothian House, Dalkeith, EH22 1DN

Present:

Peter Smaill (Chair)
Councillor Hardie
Councillor Milligan
Councillor Muirhead
Peter de Vink (Independent Member)

In attendance:

Grace Vickers	Chief Executive
Kevin Anderson	Acting Director Resources
Mary Smith	Director of Education, Communities and Economy
Allister Short	Joint Director of Health and Social Care
Gary Fairley	Head of Finance and Integrated Service Support
Stephen Reid	Ernst and Young, External Auditors
Jill Stacey	Chief Internal Auditor
Chris Lawson	Risk Manager
William Fortune	Senior Analyst
Janet Ritchie	Democratic Services Officer

1. Welcome and Apologies

- 1.1 Apologies were received from Mike Ramsay (Independent Chair) and Councillor Parry.
- 1.2 In the absence of the Chair, Councillor Smaill was appointed as Chair by the Committee, nominated by Councillor Milligan and seconded by Councillor Hardie.

2. Order of Business

The order of business was as set on the Agenda.

3. Declarations of interest

No declarations of interest were received.

4. Minutes of Previous Meetings

- 4.1 The minute of 25 September 2018 was submitted and approved as a correct record subject to the following amended paragraph under Item 5.2:

'Mr Peter de Vink expressed his concerns regarding the risk exposure which was associated with the approach taken by the Council to Treasury Management'.

- 4.2 The Action log was submitted and the following agreed:
 - a) To note that Annual Governance Statement 2017/18 (2018/19 Areas for Improvement) was on the Agenda for discussion.
 - b) To note the update provided by the Joint Director of Health and Social Care relating to Follow-up Review of Audit Recommendations on the use of Egress by care providers and on staff debt and it was agreed to close this action.
 - c) To otherwise note the actions which were closed at the last meeting.

5. Public Reports

Title	Presented by:
Data Analytic Presentation	Chief Executive
Outline of report and summary of discussion	
The Chief Executive introduced William Fortune, Senior Analyst who provided the Committee with a presentation on the new Dashboards. The Dashboard system was a front line system which pulled up to date information from various sources into one place.	

This new system would allow Managers to retrieve information and allow them to drill down to extract specific information on data stored e.g. Sickness Absence, Staff Mileage and Staff Earnings. The information pulled through was from data already stored but this information could be expanded on as required.

The Joint Director of Health and Social Care also provided examples on the ease of retrieving real time data quickly from the NHS Lothian system.

Thereafter Officers responded to questions and comments from the Committee.

Report No.	Report Title	Submitted by:
5.1	Financial Monitoring 2017/18 and Financial Strategy 2018/19 to 2021/22	Acting Director Resources
Outline of report and summary of discussion		
<p>There was a report presented to the Audit Committee by the Head of Finance and Integrated Services Support bringing the Committee's attention to the reports previously presented to Council in relation to the Financial Strategy 2018/19 to 2021/22 and Financial Monitoring 2017/18. The report refers to the following reports:</p> <ul style="list-style-type: none"> • Financial Monitoring 2018/19 – General Fund Revenue • General Services Capital Plan 2018/19 • Housing Revenue Account • Financial Strategy 2019/20 to 2022/23 • Capital Investment Strategy 		
Decision		
The Audit Committee noted the content of the Report.		

Report No.	Report Title	Submitted by:
5.2	Treasury Management Mid-Year Review Report 2018/19	Acting Director Resources
Outline of report and summary of discussion		
<p>There was a report presented to the Audit Committee by the Head of Finance and Integrated Services Support bringing the Committee's attention to the Treasury Management Mid-Year Review 2018/19 approved by the Council at its meeting on 13 November 2018.</p> <p>The Head of Finance and Integrated Services Support provided the Committee with a brief outline of the report highlighting the main sections contained within the report.</p>		

He advised the Committee that The Prudential Code recommended that the main Treasury Management reports are presented to the Audit Committee in advance of Council and that the dates for future Audit Committee meetings had been arranged to take this into consideration.

Thereafter he responded to comments and questions raised by Members of the Committee in particular with regards to the management of the Local Authority's borrowing, investment and cash flows, its banking, money market and capital market transactions and the effective control of the risks associated with those activities. The Head of Finance and Integrated Services Support noted the comments from the members of the Committee which he would take into account when preparing the Treasury Management Strategy for the Audit Committee's consideration in January and then on to Council for approval.

The Chief Internal Auditor advised that as part of the Audit Committee self-evaluation 2017/18 exercise that a briefing would be beneficial to Members on some of the technical aspects of the Treasury Management Strategy and it was therefore proposed that a briefing would be presented at the January meeting.

Decision

The Audit Committee:

- Agreed that a briefing would be presented to the members of the Audit Committee in January 2019 in relation to the Treasury Management Strategy.
- To otherwise note the content of the report.

Action

Head of Finance and Integrated Services Support, Chief Internal Auditor and Democratic Services.

Report No.	Report Title	Submitted by:
5.3	Procurement Service Delivery Framework and Procurement Strategy 2018 – 2023	Acting Director Resources
Outline of report and summary of discussion		
<p>There was a report presented to the Audit Committee by the Head of Finance and Integrated Services Support bringing the Committee's attention to the most recent reports considered and approved by the Council in relation to Procurement Service Delivery Framework and Procurement Strategy Framework 2018 – 2023.</p> <p>The Head of Finance and Integrated Services Support advised the Committee on the purpose of these two key procurement reports and highlighted some of the main sections contained within them. Thereafter Officers responded to questions and comments raised by the Committee.</p>		
Decision		
The Audit Committee noted the content of the report.		

Report No.	Report Title	Submitted by:
5.4	Final Internal Audit Report – Following the Public Pound	Chief Internal Auditor
Outline of report and summary of discussion		
<p>The purpose of this audit was to review the controls in place to ensure compliance with the Code of Guidance on Funding External bodies and Following the Public Pound (FTPP) 1996, published by COSLA (Convention of Scottish and Local Authorities) and best practice guidance.</p> <p>The Final Internal Audit Report – Following the Public Pound Report dated 21 November 2018 was presented by the Chief Internal Auditor advising the Committee of the adequate governance arrangements in place and highlighted the recommendations contained within the report.</p>		
Decision		
The Audit Committee noted the content of the report.		

Report No.	Report Title	Submitted by:
5.5	Final Internal Audit Report – Tyne Esk LEADER Programme	Chief Internal Auditor
Outline of report and summary of discussion		
<p>The purpose of the Audit was to follow-up on the recommendations made in the 2017/18 audit of the Tyne Esk LEADER Programme to ensure that the recommendations have been implemented adequately. This follow-up review contributed to the governance arrangements of the programme, helped to ensure compliance with the programme's various reporting and administrative requirements, and formed the basis of the annual internal audit coverage of the programme for the period 16 October 2017 to 15 October 2018 as required by the Service Level Agreement (SLA) with the Scottish Government.</p> <p>The Final Internal Audit Report of the Tyne Esk LEADER Programme was presented by the Chief Internal Auditor updating the Committee on the audit testing of the sample projects and the positive improvements since previous years.</p> <p>Thereafter Officers responded to questions and comments raised by Members of the Committee.</p>		
Decision		
The Audit Committee noted the content of the report.		

Report No.	Report Title	Submitted by:
5.6	Update on Progress with Implementation of Internal Audit Recommendations arising from the May 2018 Report	Chief Executive
Outline of report and summary of discussion		
<p>The purpose of the report dated 28 November 2018 was to provide an update to the Audit Committee on Management's progress with implementation of Internal Audit Recommendations arising from the May 2018 report.</p> <p>The Chief Executive highlighted the main sections contained within the report and that Appendix 1 to the report outlined the progress of the Internal Audit Recommendations arising from the May 2018 Report.</p>		
Decision		
The Audit Committee considered the progress made by Management against the Internal Audit Recommendations arising from the May 2018 Report.		

Report No.	Report Title	Submitted by:
5.7	Update on Corporate Governance 2018/19 Areas of Improvement	Chief Executive
Outline of report and summary of discussion		
<p>The purpose of the report dated 28 November 2018 was to provide an update to the Audit Committee on the Council's progress with the implementation of Actions associated with Areas of Improvement in its Annual Governance Statement 2017/18</p> <p>The Chief Executive advised the Committee that it was agreed at the Audit Committee meeting on 25 September 2018 that an update would be provided on Corporate Governance 2018/19 Areas of Improvement progress on a quarterly basis.</p>		
Decision		
The Committee considered the progress made by Management against the Corporate Governance 2018/19 Areas of Improvement, and noted that the next update to the Audit Committee would be included within the Annual Governance Statement 2018/19 as part of standard practice.		

Report No.	Report Title	Submitted by:
5.8	Internal Audit Mid-Term Performance Report 2018/19	Chief Internal Auditor
Outline of report and summary of discussion		

The purpose of this report was to inform the Audit Committee of the progress Internal Audit has made, in the first 6 months of the year to 30 September 2018, towards completing the Internal Audit Annual Plan 2018/19. It also summarises the statutory obligations for Internal Audit and requirements of the Public Sector Internal Audit Standards.

The Chief Internal Auditor highlighted that the Internal Audit Annual Plan 2018/19 had been approved by the Audit Committee on March 2018 and she provided the Committee with a brief outline of the content of this report.

The Chief Internal Auditor also updated the Committee on the proposal to defer three of the planned Assurance audit activities to the 2019/20 plan and the changes proposed to the Internal Audit Annual Plan 2018/19 would therefore require approval by the Committee.

Decision

The Audit Committee:

- Noted the progress Internal Audit had made with activity in the Internal Audit Annual Plan 2018/19 by the mid-year point; and
- Approved the revised Internal Audit Annual Plan 2018/19 as set out in Appendix 1 that reflected the proposals set out in this report and was achievable within current staff resources.

Report No.	Report Title	Submitted by:
5.9	Shared Internal Audit Services between Midlothian and Scottish Borders Councils	Chief Executive
Outline of report and summary of discussion		
<p>The purpose of this report was to gain approval to the proposal to continue with shared Internal Audit services between Midlothian and Scottish Borders Councils which will also create the opportunity for a wider exploration of joint working activities and benefits.</p> <p>The Chief Executive highlighted the main sections contained within the report and the recommendations as detailed in section 7.</p>		
Decision		
<p>The Audit Committee:</p> <ul style="list-style-type: none"> • Endorsed the continuation of the Shared Internal Audit Services as a permanent arrangement to provide greater certainty and allow for longer term planning of work and teams, recognising that either Council could still decide to opt out/revert back at any time subject to an appropriate period of notice. • Noted that there would be a wider exploration of joint working associated with the above in both the short and longer term across the Councils. 		

Report No.	Report Title	Submitted by:
5.10	Risk Management Update 1 July 2018 – 30 September 2018	Risk Manager
Outline of report and summary of discussion		
<p>The Risk Manager presented a report dated 5 December 2018 providing the Audit Committee with the 2018/19 Quarter 2 strategic risk management update, covering the period 1 July 2018 to 30 September 2018. It being noted that the Audit Committee had previously requested regular reports on the Council's Strategic Risks. The Strategic Risk Profile sought to provide a strategic look at the current issues and future risks and opportunities facing the Council.</p> <p>Thereafter the Risk Manager confirmed in response to a question raised by the Chair that the Risk Assessment would be updated on completion of the roads investigation.</p>		
Decision		
<p>The Audit Committee noted:</p> <ul style="list-style-type: none"> • The addition of (Early Years Expansion) and Cyber Security in the strategic profile as set out in the attached appendix. • The Quarter 2 2018/19 Strategic Risk Profile report and considered the current response to the issues, risks and opportunities highlighted. 		

Report No.	Report Title
5.11	Local Government in Scotland Financial Overview 2017/18
Outline of report and summary of discussion	
<p>This report reflected a similar situation to last year as Councils face an increasingly complex range of challenges and continuing pressure on finances. Challenges included increasing demand across many of the wide range of services councils deliver to local communities. Demand had to be met against tightening budgets in many service areas along with uncertainty stemming from external factors such as EU withdrawal.</p> <p>The Head of Finance and Integrated Services Support highlighted the main sections contained within the report in particular the Summary section which outlined 7 key messages.</p> <p>There followed a general discussion during which it was agreed that this Report be presented to the January 2019 meeting with a supporting report outlining Midlothian's position.</p>	
Decision	
<p>The Audit Committee agreed to resubmit this report to the January 2019 meeting together with a report prepared by Officers.</p>	

Action
Head of Finance and Integrated Services Support and Democratic Services

6. Private Reports

No private business was discussed.

7. Date of Next Meeting

An Informal Audit Session would take place at 10 am on Tuesday 29 January 2019 prior to the commencement of the Audit Committee at 11.00 am on that day.

The Clerk advised the Committee that Mike Ramsay, Independent Chair had intimated his apologies for the meeting scheduled for 29 January 2019. It was therefore agreed that Councillor Smaill would take the Chair at this meeting.

The meeting terminated at 12.55 pm

Actions Log

Audit Committee
Tuesday 29 January 2019
Item No: 4.2



No	Subject	Date	Action	Action Owner	Expected completion date	Comments
1	Annual Governance Statement 2017/18 (2018/19 Areas for Improvement)	19/06/18		Chief Executive	June 2019	Final AGS 2017/18 included within audited Statement of Accounts 2017/18 for 25/09/2018. Management's proposal is to report on Areas of Improvement progress to Audit Committee on a quarterly basis.
2	Follow-up Review of Audit Recommendations	25/09/18	Updates to be provided to Members on - staff arrears, and use of the Council's secure email system (Egress) by care home providers to send monthly performance reports and accident/incident reports.	Joint Director, Health and Social Care	Complete	Update provided at 11/12/2018 by Joint Director Health and Social Care: All Care Homes are now using the Council's Egress system; and arrears amount for all Council staff stated.

No	Subject	Date	Action	Action Owner	Expected completion date	Comments
3	Briefing – Informal Audit Committee Session	11/12/18	Agreed that a briefing would be presented to the members in January 2019 in relation to the Treasury Management Strategy.	Head of Finance and Integrated Services Support/Chief Internal Auditor	29/01/2019	Informal Session prior to formal Committee meeting on 29 January 2019 to focus on Treasury Management.
4	Local Government in Scotland Financial Overview 2017/18	11/12/18	The Audit Committee agreed to carry this report forward to the January 2019 meeting and a report prepared by Officers in connection with this report.	Head of Finance and Integrated Services Support	29/01/2019	Report included within agenda for Audit Committee 29 January 2019.

Audit Scotland Report: Local government in Scotland: Financial Overview 2017/18 (Audit Scotland, November 2018)**Report by: Gary Fairley, Head of Finance and Integrated Service Support****1 Purpose of the Report**

To provide Audit Committee with a summary of the Audit Scotland report, 'Local government in Scotland: Financial Overview 2017/18' and the Council's position in relation to the report's findings. Link to the full report here:

<http://www.audit-scotland.gov.uk/report/local-government-in-scotland-financial-overview-201718>

2 Background

2.1 Each year the Accounts Commission produces an overview of issues that have arisen from their local authority audits. In line with the previous publications these will again be encompassed in two reports. The first report, which is covered in this paper, focuses on financial matters, and the other, which will be published on 14 March 2019 will focus on council's performance and outcomes.

2.2 Local government in Scotland: Financial Overview 2017/18 was published by the Accounts Commission in November 2018 and was included on the agenda of the last Audit Committee. The report provides a high-level, independent view of Councils financial performance and position in 2017/18. It is aimed primarily at Councillors and senior council officers as a source of information and to support them in their complex and demanding roles. It is in four parts:

- Part 1 Council's budgets and spending in 2017/18.
- Part 2 Council's financial position.
- Part 3 Integration Joint Boards' overview 2017/18
- Part 4 Council's financial outlook.

2.3 The report is the first of the Account's Commission overview outputs. It tells the strategic financial story for local government in Scotland in 2017/18, another challenging year for Councils. The report notes that there was a real term reduction in councils' main source of funding from Scottish Government for 2017/18 and advised that councils an increasingly complex range of challenges and continuing pressure on finances. With the forecast trend for further reductions in funding from

Scottish Government in the medium term the Accounts Commission noted that pressure remains on councils to make further savings and the need to find ways to meet service demand more efficiently and effectively. Further noting that this will require difficult decisions and innovative thinking by councillors and senior management working together.

- 2.4** The report further noted that most councils now have medium-term financial plans in place and therefore encouraged all councils to build on medium-term plans and develop suitable long-term financial planning. Adding that this should support consistency in financial decisions with corporate priorities' as well as supporting transformation initiatives.
- 2.5** The Accounts Commission, in referencing the previously highlighted risk of councils planning to use significant amount of reserves to manage funding gaps were pleased to note that for this year, although overall reserves continued to reduce, no council is using its reserves at the level that risks their financial sustainability in the next two to three years.
- 2.5** The Commission also recognised that one of the other most significant challenges for councils are financial issues associated with the Integrated Joint Boards (IJBs).
- 2.6** The key messages identified in the 2017/18 report include:
- Councils depend on Scottish Government funding for a significant part of their income. Scottish Government revenue funding to councils reduced in 2017/18, in cash terms by 0.6 per cent (£0.06 billion) and in real terms, by 2.3 per cent (£0.22 billion). Council tax increases and increased fees and charges were used by councils to increase overall budgets by £0.3 billion (cash terms).
 - In 2017/18, councils managed funding gaps of four per cent in their net expenditure budgets of £12 billion, mainly through savings and planned use of reserves. Councils are under pressure to find different ways to fund and deliver services. In 2017/18, 24 councils increased council tax, whereas in 2018/19, all councils increased council tax.
 - Overall increases in spending in Education and Social Work were offset by reductions in other services.
 - Eighteen councils ended 2017/18 with lower levels of usable reserves than they had at the start of the year. Total usable reserves fell by £18 million, a relatively small amount.
 - Funding to the Integration Joint Boards (IJBs) increased in 2017/18 by three per cent in cash terms (1.4 per cent in real terms), including additional funding from the NHS. The majority of IJBs have underlying financial sustainability issues, with 20 incurring deficits or dependent on additional ('deficit') funding from their partners.
 - The financial outlook is for reductions in Scottish Government revenue funding to councils. This will mean continued and increasing financial pressures on council services, especially those that are not protected.

- The impact of EU withdrawal is not yet clear, but councils need to identify the risks and develop contingency plans to manage these risks.

3 Financial Overview 2017/18

3.1 Part 1 – Councils’ budgets and spending in 2017/18. Key messages:

1. Councils depend on Scottish Government funding for a significant part of their income. Scottish Government revenue funding to councils reduced by 2.3 per cent (£0.2 billion) in real terms in 2017/18, but council tax, grants to services and fees and charges increased, and overall budgets grew by £0.3 billion in cash terms.
2. Between 2013/14 and 2017/18, funding from the Scottish Government to local government decreased at a faster rate, 6.92 per cent, than the Scottish Government revenue budget at 1.65 per cent.
3. Distribution of funding from the Scottish Government is based mainly on population but could be more transparent to ensure clarity about how funding distribution reflects factors that drive demand and costs in councils.
4. In 2017/18, councils managed funding gaps of four per cent in their net expenditure budgets of £12 billion, mainly through savings and planned use of reserves. Their outturn at the year-end was better than budgeted.
5. Overall increases in spending in Education and Social Work were offset by reductions in other services.

These key messages reflect the challenges Midlothian Council faced when setting a budget for 2017/18. The 2017/18 budget included a package of measures to address a £12.431 million budget shortfall which included a £3.970 million utilisation of reserves. The final outturn reported to Council in June 2018 showed a net overspend for the year, met from reserves of £0.622 million.

The same challenges continue in the current financial year and are exacerbated by the cut to core grant funding in the 2019/20 grant settlement.

3.2 Part 2 – Councils’ financial position. Key messages:

1. Eighteen councils drew on their usable reserves in 2017/18, overall by a relatively small amount.
2. Some councils have relatively higher levels of debt for their size.
3. Local policies vary on whether cash and investments are held to support reserves. This could increase the need for further future borrowing.
4. Capital expenditure in 2017/18 decreased by five per cent in real terms. Housing and education were the main areas of investment.

Despite this the number of social houses provided by councils continues to fall.

5. Some councils have had significant increases in their debt positions.
6. There were delays with the valuation of pensions liabilities in councils across Scotland in 2017/18, but the net pension liability has reduced substantially in 2017/18.
7. Management commentaries in councils' accounts should do more to explain financial outturn against budget.

Again the key messages reflect the challenges the Council faces. As the resources available to the Council continue to reduce in both cash and real terms it is increasingly important that there is a robust budget setting process and that robust financial management and reporting is maintained. Council has a continued requirement to invest in assets to support the growing population. Though the level of borrowing is increasing the Treasury Management Strategy and prudential indicators provide Council with reassurance that this level of investment is financially sustainable and can be serviced from the revenue budget.

There is no doubt that difficult decisions lie ahead for all Councils and the report highlights the importance of being proactive in addressing the financial pressures.

3.3 Part 3 – Integration Joint Boards' overview 2017/18. Key messages:

1. Funding to the IJBs increased in 2017/18 by three per cent in cash terms. Most of this additional funding came from the NHS and includes additional Scottish Government funding to the NHS for IJBs of £107 million.
2. The majority of IJBs have underlying financial sustainability issues, with 11 out of 30 incurring deficits in 2017/18. A further eight would have incurred deficits without additional ('deficit') funding from their partners.
3. Reserve positions vary enormously between IJBs.
4. Medium-term financial planning is not used by most IJBs and further improvements to financial management should be introduced.

The Midlothian IJB ended the financial Year with a small reserve carried forward to the current financial year, and like all IJB's continues to face significant financial challenges given the increasing demand for services.

3.4 Part 4 – Councils' financial outlook. Key messages:

1. In 2018/19, Scottish Government revenue funding to local government increased by 0.2 per cent after two years of real-terms reductions.
2. The Scottish Government published a five-year financial strategy in May 2018, but multi-year budgets are not yet being developed. The

financial strategy identifies greater future uncertainty and likely further reductions of nine per cent in real terms over the next five years in 'other non-protected' council funding.

3. Many councils are in the early stages of delivering transformational change.
4. Medium-term financial planning has been adopted by almost all councils, but less than half have significant long-term plans over five years.
5. Councils expect to manage smaller funding gaps in 2018/19 of £0.3 billion (two per cent), with all 32 councils raising council tax rates by three per cent in 2018/19. There are no councils where the budgeted use of reserves is a critical issue over the next three years.
6. The impact of EU withdrawal is not yet clear, but councils need to identify the risks and develop contingency plans to manage these risks, as far as possible.

The 2019/20 grant settlement published in December 2018 represents a very challenging settlement for all of Local Government with a cut to funding for core services of £237 million or 2.4%. The budget shortfall for 2019/20 reported to Council on 18 December 2018 was £9.591 million and this has been exacerbated by the settlement.

Council will be provided with the final assessment of the budget shortfall for 2019/20 when it meets on 12 February 2019 to set its budget for 2019/20. Inevitable with reducing resources and continued inflationary and demand led pressures to secure a balanced budget will require cuts across a range of services for the year ahead.

5 Report Implications

5.1 Resource

There are no additional resource implications.

5.2 Risk

There are no additional direct risks associated with this report.

5.3 Single Midlothian Plan

Themes addressed in this report:

- ☐ Community safety
- ☐ Adult health, care and housing
- ☐ Getting it right for every Midlothian child
- ☐ Improving opportunities in Midlothian
- ☐ Sustainable growth
- ☒ Business transformation and Best Value
- ☐ None of the above

5.4 Key Priorities within Single Midlothian Plan

Midlothian Council and its Community Planning Partners have made a commitment to treat the following areas as key priorities under the Single Midlothian Plan:-

- Reducing the gap in learning outcomes
- Reducing the gap in health outcomes
- Reducing the gap in economic circumstances

This report does not directly impact Midlothian Council's key priorities but a key message within the Audit Scotland Report does make reference to the need to respond to key priorities and outcomes.

5.5 Impact on Performance and Outcomes

The report does not directly impact Midlothian Council's and wider partners performance and outcomes but it does stress the need to ensure consideration is given to the wider strategic planning and objectives as part of the council's response to Audit Scotland's findings noted in their report.

5.6 Adopting a Preventative Approach

This report does not directly impact actions and plans in place to adopt a preventative approach.

5.7 Involving Communities and Other Stakeholders

This report does not directly relate to involving communities and stakeholders.

5.8 Ensuring Equalities

This report does not recommend any change to policy or practice and therefore does not require an Equalities Impact Assessment.

5.9 Supporting Sustainable Development

The recommendations in this report support Midlothian Council's position in relation to delivering sustainable services going forward.

5.10 IT Issues

There are no IT issues arising from this report at this time.

6 Recommendations

The Committee is asked to note the Audit Scotland report and the position of Midlothian Council in relation to the report's key messages.

Date: 21 January 2019

Report Contact: Gary Fairley
gary.fariley@midlothian.gov.uk

Tel No: 0131 271 3110

Background Papers:

Accounts Commission - Local government in Scotland: Financial Overview 2017/18 – (November 2018).



Chief Internal Auditor
Jill Stacey

Audit Committee
Tuesday 29 January 2019
Item No: 5.2

Auditor: Amber Ahmed, Ext 3280

Final Internal Audit Report

to

- Chief Executive
- All Directors
- All Heads of Service
- Business Services Manager
- Employment and Reward Manager
- Business Applications Manager

on

Payroll

21 November 2018

1 Introduction

1.1 The purpose of this audit was to review the adequacy of the control framework over starters and leavers within Midlothian Council.

2 Audit Scope

2.1 The scope of this audit was to examine and evaluate the following areas:

- checks undertaken before an employee is offered a contract. This included checking work permits, personal identification, references, Protecting Vulnerable Groups (PVG), any monies due to the Council, and any other checks relevant for the job role;
- data entered into the payroll system is supported by appropriate, authorised documentation which has been validated;
- employee data is processed appropriately; and
- documentation is submitted timeously and in a consistent way e.g. employment contracts, exit arrangements.

3 Management Summary

- 3.1 The Council operates three main payrolls. These are the monthly payroll (661), the four-weekly payroll (Lunar Payroll) (662), and the Teachers' payroll (671). Additionally, there is a separate payroll run for Election workers. Midlothian Council uses Midland's HR iTrent system to process and control its payroll services which is managed and prepared by the Employment and Reward team. Payments are processed via BACS which is undertaken by the Financial Services Team. Documents are scanned and saved on the Council's Document Management system, CS10. System management and software updates of the iTrent system are controlled by the Business Applications team. Upgrades and backups to the iTrent and CS10 system are carried out on a frequent basis.
- 3.2 For the purposes of IR35 reporting, Service Managers across the Council are required to inform the Employment and Reward team of agency workers who are working in their area for more than 1 week. Agency workers are registered on the 'on/off payroll system' via iTrent but are not paid through the payroll system.
- 3.3 Internal Audit testing was performed on a judgemental sample basis and focused on all areas across the Council to assess the adequacy and effectiveness of new starts and leavers processed during the financial year 2017/18. 1,040 new starts and 812 leavers were recorded on the iTrent system (this also included permanent and temporary changes). A sample of 27 new starts and 20 leavers were selected and the results of the testing undertaken are stated in section 4 of this report.

- 3.4 The following examples of good practice were found:
- recruitment and leaver guidance is available on the Council's Intranet;
 - a 'New Post Authorisation Form' is used by Senior Management to authorise a new post;
 - where a PVG check is required, this is clearly stated in the recruitment requirements;
 - a recruitment checklist is used by Employment and Reward officers for the creation of new starts; and
 - the old iTrent leaver form has been replaced with a new online form on CS10 which reaches Employment and Reward team instantly when it is submitted by the Service Manager. The online electronic workflow forms were launched to corporate-based managers and the intention is to replace the online word form with similar workflows to managers based in schools in the near future.
- 3.5 Improvements are required for: ensuring Services submit information to the Employment and Reward team on a timely basis to avoid an overpayment for a leaver and to ensure appropriate recruitment checks are undertaken before an employee starts working for the Council or changes status; documenting the practice for dealing with appeals of an overpayment of salary; ensuring complete documentation for leavers and starters; and enhancing the quality assurance checking of data input into the iTrent system.
- 3.6 Internal Audit considers that the level of assurance we are able to give is Substantial Assurance.
- 3.7 The Internal Audit function conforms with the professional standards as set out in the Public Sector Internal Audit Standards (2017), including the production of this report to communicate the results of the review.
- 3.8 We would like to thank those officers who assisted us during our review.

4 Findings

Risk	Expected Control	Results	Effectiveness of Actual Control	Rec. Ref No
4.1 Risk of financial loss or reputation damage if the Council employs an individual who is barred from doing a type of regulated work or doesn't have the necessary qualifications / experience required for the role.	Adequate controls are in place to ensure checks are undertaken before an individual is offered a contract of employment and data is processed appropriately.	<p><u>Recruitment checks</u> From a sample of 27 new starts tested, adequate controls over the pre-employment checks required were found to be in place with the exception of 4 cases. For these cases, issues were noted such as: 2 where employment commenced prior to Disclosure Scotland checks being completed (it has been advised that in these instances a risk assessment should be completed and approval from the Lead Signatory should be sought – this was not evidenced for these cases), 1 where the Employment and Reward Team (ERT) were advised of a new start after employment had commenced and 2 where references were not submitted to ERT.</p> <p>A new process is in place when an employee changes status from a casual post into a fixed term or permanent post and further controls will be considered to reduce potential errors that may arise.</p> <p><u>PVG Policy and Procedure</u> A comprehensive PVG policy and procedure is available on the Intranet. Roles can change between recruitment exercises both in remit and structure which can change the disclosure requirement. ERT advise managers of requirements needed for the post before it is advertised.</p> <p><u>Authorised Signatory System</u> From our sample of 27 new starts, forms were approved by the appropriate manager with the exception of 3 new start forms. A review of authorised signatories is underway arising from another audit which will include the authority to process new starts and leavers.</p> <p><u>System Data</u> From our 27 new starts sample, 26 employee details were correctly entered on the iTrent system and corresponded with the forms with the exception of 1 case where a date of birth was entered incorrectly. The system has since been updated with the correct details. We found 1 employee had been entered into the iTrent system as a casual worker in May 2017 but has never worked for the Council.</p>	<p>Satisfactory with a few exceptions</p> <p>Good</p> <p>Good</p> <p>Satisfactory</p>	5.1
			Satisfactory subject to data quality checking and regular cleanse	5.2

Risk	Expected Control	Results	Effectiveness of Actual Control	Rec. Ref No
4.2 Risk of financial loss or reputation damage if those exiting the Council are not processed promptly and adequately.	Data entered into the payroll system is supported by appropriate, authorised documentation which has been validated.	<u>Leaver Forms</u> From our sample of 20 leavers, forms were approved by the appropriate manager with the exception of 6 leaver forms which were not stored in the electronic employee file and thus could not be verified (payments for these employees have ceased and a contract end date is recorded on the iTrent system however an overpayment of £126 occurred for 1 of these cases).	Satisfactory subject to improving audit trails	5.3
		<u>Documentation</u> From the sample of 14 leavers' documentation that were available, 1 pension form was not copied to CS10, and only 6 cases had resignation letters/emails attached to the leaver forms (though it is noted that resignation is sometimes confirmed via phone call).	Satisfactory subject to improving audit trails	5.3
		<u>Overpayments</u> From the sample of leaver forms, 5 were sent to ERT outwith the timescales in the Leavers' Guidance though none of these 5 cases resulted in an overpayment. In our sample of 20 cases examined, 1 overpayment of salary (disputed account which occurred due to an error made by the Council) was reduced by the Employment and Reward Manager. It was advised that this was based on the practice for dealing with appeals of this nature (approved by the Director, Resources based on the common law Estoppel principle) however this was not documented and the Manager was not on the authorised signatory list for authorising credit notes. The External Audit 2017/18 report highlighted a control issue which resulted in an overpayment.	Satisfactory subject to documentation of process and update of signatory database	5.4
		<u>Leavers' Report</u> The modified leaver report was recommended in the Purchasing Card Internal Audit Report to ensure late leavers updated on the iTrent system by Services are captured on the Leavers' Report.	Satisfactory	Previous audit rec
		<u>Processing</u> From our sample of leaver forms, we found 5 cases when information was submitted by Services on time but leaver letters were sent out late by ERT though this did not result in an overpayment as payroll elements were updated on the iTrent system. There was a period due to resource issues that resulted in a backlog of leaver processing, though cross training involving a greater number of staff in ERT has since resolved this.	Satisfactory	

5 Recommendations

Rec. No	Recommendation	Rating	Management Response	Responsibility and Timescale
5.1	Services should be reminded by the Employment and Reward Manager that appropriate checks are undertaken in compliance with HR Guidance and documents for new starts and leavers are promptly submitted to the Employment and Reward Team.	Medium	A new Additional Services policy is due to be implemented and a leavers' process change introduced which will include updating forms and guidance for Managers to ensure forms are sent promptly.	Employment and Reward Manager, 31 December 2018
5.2	Quality assurance checking of data entered into the iTrent system and a periodic system review should be undertaken to ensure data is accurate and complete.	Medium	A percentage of random quality checking process within the Employment and Reward team will be implemented. An annual purge of the iTrent system is due to be undertaken. Employees will be requested to update personal data in 2019 to ensure GDPR regulations are complied with. The various control reports utilised by business areas will be updated to pick up late position/organisation leavers so system access can be removed and/or amended accordingly.	Employment and Reward Manager, 31 December 2018
5.3	All documents for starters and leavers should be available on CS10.	Medium	The Employment and Reward Operations Leader traced the missing leaver files. Half were VSER leavers which were deliberately saved in the "P" drive as agreed by the Project Board so they were accessible to those required to substantiate the business case (i.e. HR Business Partners, Accountants, Directors and Heads of Service). 1 was misfiled in the wrong folder of their employee e-file and 1 was held in a secure folder as the case was a disciplinary outcome.	Complete
5.4	The practice for dealing with appeals of an overpayment of salary (approved by the Director, Resources based on the common law Estoppel principle) should be formally documented and the authorised signatory database should be updated to reflect the authority limits of the Employment & Reward Manager.	Medium	The authorisation required for this process has been updated on the authorised signatory database and delegation to the Employment & Reward Manager to be properly documented.	Head of Finance and Integrated Service Support, 31 March 2019

Overall Audit Opinion level and definition

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

Recommendation Ratings

Recommendations in Internal Audit Reports are suggested changes to existing procedures or processes, to improve the controls or to introduce controls where none exist. The rating of each recommendation reflects our risk assessment of non-implementation, being the product of the likelihood of the risk materialising and its impact. The ratings are:

High	Significant weaknesses in existing controls, leaving the Council or Service open to error, fraud, financial loss or reputational damage, where the risk is sufficiently high to require immediate action within one month of formally raising the issue. The risk should be added by Management to the relevant Risk Register for control and monitoring purposes and included in the relevant Head of Service Annual Assurance Statement.
Medium	Substantial weaknesses in existing controls, leaving the Council or Service open to medium risk of error, fraud, financial loss or reputational damage requiring reasonably urgent action within three months of formally raising the issue.
Low	Moderate weaknesses in existing controls, leaving the Council or Service open to low risk of error, fraud, financial loss or reputational damage requiring action within six months of formally raising the issue to improve efficiency, effectiveness and economy of operations or which otherwise require to be brought to the attention of Senior Management.
Other	Minor administrative weaknesses posing little risk of error, fraud, financial loss or reputational damage.

The Action Plans in Internal Audit Reports address only Recommendations rated High, Medium or Low. Outwith the Internal Audit Report, we inform Service Management about Other Minor matters to improve internal control and governance.

The recommendations will be input to Pentana performance system to assist with Management tracking of implementation. If responsible owners are unable to achieve the standard timescales for actions please notify the Chief Internal Auditor with the reason for the delay in implementation and the revised timescales to assist with the implementation and follow-up of these recommendations to improve internal control and governance.

Jill Stacey
Chief Internal Auditor

Internal Audit Recommendations Progress Report

Report by Chief Internal Auditor

1 Purpose of Report

The purpose of this report is to inform the Audit Committee of the number of recommendations raised by Internal Audit over the last 4 years and the Council's performance in addressing these issues by the agreed implementation dates.

2 Background

- 2.1 Internal Audit suggests recommendations for improving internal control and to assist the Council deliver best value. Where Management and the Audit Committee agree these recommendations, the issues are updated to Pentana Performance (the Council's performance management system) along with a date by which Management should have completed the agreed action.
- 2.2 Each year, Internal Audit undertakes two follow up reviews on recommendations raised. The first samples recommendations which have been reported as complete and reviews the adequacy of the actions taken (reported to the 25 September 2018 Audit Committee). The second reports on the progress Management have made in completing and closing the recommendations by the expected date (which is the subject of this report).
- 2.3 Part of the Audit Committee's role is to monitor progress in addressing risk-related issues reported to the Committee, and to consider reports on the effectiveness of internal controls and monitor the implementation of agreed actions.

3 Performance

- 3.1 Over the period 2015/16 to October 2018, Internal Audit has raised a total of 457 recommendations. 395 of these are reported as having been completed (86%), 46 have not yet reached their due date (10%), and 16 are showing as overdue (4%).
- 3.2 The recommendations that have gone over their expected completion dates are detailed within Appendix 1 along with the current progress made against the action and the latest Management update.
- 3.3 Contrasting this performance to the previous Internal Audit report presented to the Audit Committee in December 2017 (covering the period 2014/15 to October 2017), Internal Audit had raised a total of 402 recommendations. 324 of these were reported as having been completed (81%), 36 had not reached their due date (9%) and 42 were showing as overdue (10%).

- 3.4 There is a reduction in overdue recommendations compared to the previous year's report. The majority of these recommendations are well underway and many are almost complete (refer to Appendix 1).
- 3.5 The results of this analysis have been discussed with the Corporate Management Team and the Strategic Leadership Group as part of their responsibility to design and maintain proper risk management, governance and internal control processes and checking that the arrangements and controls are operating effectively. These are known as the first and second lines of defence.

4 Report Implications

4.1 Resource

There are no direct resource implications arising from the report.

4.2 Risk

The recommendations made by Internal Audit are directly related to reducing the level of risk to which the Council is exposed through the strengthening of the control environment and management of risks.

4.3 Single Midlothian Plan and Business Transformation

Themes addressed in this report:

- ☒ Community safety
- ☒ Adult health, care and housing
- ☒ Getting it right for every Midlothian child
- ☒ Improving opportunities in Midlothian
- ☒ Sustainable growth
- ☒ Business transformation and Best Value
- ☐ None of the above

4.4 Key Priorities within the Single Midlothian Plan

Internal Audit reports review internal controls across the Council including those that relate to the key priorities within the Single Midlothian Plan.

4.5 Impact on Performance and Outcomes

The report identifies the performance of the Council in closing Internal Audit recommendations by the agreed implementation date.

4.6 Adopting a Preventative Approach

Adoption of the Internal Audit recommendations assists in preventing the risks facing Midlothian Council materialising through the strengthening of the control environment and management of risks, therefore assisting the organisation in achieving its objectives.

4.7 Involving Communities and Other Stakeholders

The Council delivers its services through appropriate engagement with communities or other stakeholders.

4.8 Ensuring Equalities

There are no equalities issues with regard to this report.

4.9 Supporting Sustainable Development

There are no sustainability issues with regard to this report.

4.10 IT Issues

There are no IT issues with regard to this report.

5 Recommendations

The Audit Committee is asked to:

- note the content of the report;
- approve the revised implementation dates as shown in Appendix 1; and
- note that Internal Audit will continue to monitor for completion of the outstanding recommendations and will provide reports to the Audit Committee.

Date: 18 January 2019

Report Contacts:

James Polanski, Internal Auditor Tel No 0131 270 5646
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Appendices:


Appendix 1 – Outstanding audit recommendations for Midlothian Council

Internal Audit Performance Report - Overdue Actions




Status: Overdue 16

2015 - Review of Controls Operating Over Petty Cash



Action Code	Action	Due Date	Icon	Progress	Notes	Service	Managed By
IA.CASH.05	As part of the Purchase to Pay Project, electronic petty cash forms and the scanning and attachment of receipts / vouchers to claims should be implemented across the Council (for areas with a petty cash imprest account).	31-Oct-2015		90%	Q3 18/19: Off Target Constructive feedback received from St David's HS. E-Form to be rolled out to all imprest holders in Q4. Proposed revised due date: 31/03/2019	Finance and Integrated Service Support	Jacqui Dougall; Mike O'Rourke

2016 - Devolved School Management Scheme - 3 control objectives separately rated. (Good for budget calculation, Good for budget monitoring, Weak for embedding 2012 DSM guidance)


Action Code	Action	Due Date	Icon	Progress	Notes	Service	Managed By
IA.DSMS.09	A standard training course and training pack over the operation of school budgets including the DSM allocations should be provided to head teachers and support staff when they take on budgetary	30-Sep-2017		50%	Q3 18/19: In Progress Schools Finance Assistants meet with HT's and support staff regularly and provide additional support when	Education	Sandra Banks; David Gladwin

	responsibilities. A record of this should be maintained.				requested. This is tailored to individual needs. The DSM scheme requires to be updated to reflect current rules before it can be formally shared as a full working document - responsibility for this sits with the Resources Manager in Education.		
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2017 - Monitoring of External Care Homes - Average Assurance Rating

Action Code	Action	Due Date	Icon	Progress	Notes	Service	Managed By
IA.CAREH OME.01.1	A strategy should be created detailing the monitoring and reporting that will be undertaken by the Service.	31-Mar-2018		90%	Q3 18/19: Off Target Strategy been circulated for consultation. Final report expected to be complete by the end of January. Proposed revised due date: 31/03/2019	Adult Services	Anthea Fraser; A.Short (Joint Director Midlothian Health and Social Care Partnership)
IA.CAREH OME.01.2	The strategy should include the expected level of monitoring of care homes, the frequency and timing of audits, which care homes are covered under the National Care Home contract and this should be reported on a regular basis to senior management.	31-Mar-2018		90%	Q3 18/19: Off Target. Continues to be progressed. Proposed revised due date: 31/03/2019	Adult Services	Anthea Fraser; A.Short (Joint Director Midlothian Health and Social Care Partnership)




2017 - PPP - Utilisation of Assets - Average Assurance Rating

Action Code	Action	Due Date	Icon	Progress	Notes	Service	Managed By
IA.PPP.07	Education management should carry out a scoping exercise to explore options for making the facilities at the Dalkeith Campus available to the community during school hours.	31-Dec-2017		60%	<p>Q3 18/19: Off Target Initial assessment is that the demands of 2 secondary schools and one special school for pool time does not leave much scope for making the pool available to others during school hours. Full scoping will be completed by the end of this school session</p> <p>Proposed revised due date: 30/06/2019</p>	Education	Sandra Banks


2017 - Stores - Average Assurance Rating

Action Code	Action	Due Date	Icon	Progress	Notes	Service	Managed By
IA.STORE S.01	The physical security issues that can be immediately addressed, such as controls over keys, periodic changing of door keypad code, replacement/repair of the rear fire door and locking of metal crates on the store yard, should be addressed.	31-Dec-2017		90%	<p>Q3 18/19: Off Target Replacement/Repair to rear fire door still sitting outstanding with building maintenance. Maintenance Officer has been chased on several occasions requesting urgent action. Outstanding action is sitting with Building Maintenance management team.</p> <p>Proposed revised due date: 31/03/2019</p>	Finance and Integrated Service Support	Iain Johnston



2017 - Sundry Debt - Average Assurance Rating

Action Code	Action	Due Date	Icon	Progress	Notes	Service	Managed By
IA.SDEBT.02	The Council's Financial Directives should be updated to reflect the current Council Structure.	31-Dec-2017		50%	Q2 18/19: Off Target It was originally planned to incorporate this in a fuller review of Financial Directives which has still to be scheduled into service work plans. In the interim an update of post titles etc will be progressed in the remainder of 18/19.	Finance and Integrated Service Support	Head of Finance and Integrated Service Support
IA.SDEBT.03	The procedure for Sundry Debt detailed in the Financial Directive should be expanded into a broader procedure note. Additionally, the Sundry Debt risk register should be updated quarterly.	31-Dec-2017		0%	Q3 18/19: Off Target Policy still to be created and overall Financial Directives being reviewed under IA.SDEBT.02.	Finance and Integrated Service Support	Jacqui Dougall; Kathleen Leddy
IA.SDEBT.18	Once a sample of test cases, where the Council has taken legal action on debtors has been undertaken, a procedure note for escalation should be drafted and submitted to relevant officers.	31-Dec-2017		40%	Q3 18/19: Off Target Cases progressing with legal, no procedure note drafted.	Finance and Integrated Service Support	Jacqui Dougall; Kathleen Leddy




2018 - Accounts Payable - Average Assurance Rating

Action Code	Action	Due Date	Icon	Progress	Notes	Service	Managed By
IA.ACCPAY.10	Local procedures for undertaking VAT and Control reconciliations should be generated and an adequate filing system should be in place.	30-Sep-2018		80%	Q3 18/19: Off Target First draft complete, some amendments required before final version approved. Proposed revised due date: 31/03/2019	Finance and Integrated Service Support	Mike O'Rourke


2018 - Climate Change - Average Assurance Rating

Action Code	Action	Due Date	Icon	Progress	Notes	Service	Managed By
IA.CCHAN GE.01	A new Carbon Management Plan should be in place with a new baseline and this should be reported on an annual basis to CMT or to another appropriate board which will allow the Council to monitor carbon reductions.	31-Oct-2018		0%	Q2 18/19: Off Target No action taken because of other work priorities. Initial work will involve collaboration with the Property and Facilities Management Service. However the statutory reporting requirement to Scottish Government by the end of November '18 will be achieved.	Communities and Economy	CMT
IA.CCHAN GE.06	Local procedures should be developed detailing how to collate, record and calculate information for the Climate Change Report. Procedures should document the governance process, the lead officer responsible and any validation and checking required.	30-Sep-2018		0%	Q3 18/19: Off Target No action taken because of other work priorities.	Communities and Economy	CMT

2018 - Follow-up of Audit Recommendations – Rating not applicable

Action Code	Action	Due Date	Icon	Progress	Notes	Service	Managed By
IA.FRAR20 17.01	Early Years risks should be fully updated and input into the Pentana system.	31-Mar-2018		75%	Q3 18/19: Off Target Initial scoping of risks has been undertaken and work ongoing to complete during session 18-19. Proposed revised due date: 31/03/2019	Education	Head of Education; Julie Fox
IA.FRAR20 17.14	The petty cash top-up claims forms should only be approved by those listed on the Authorised Signatory Database. The Authorised Signatory Database needs to be updated to reflect which managers are authorised to approve petty cash disbursements.	31-Mar-2018		95%	Q3 18/19: Off target Information has been gathered and reviewed. A technical change needs to take place the Authorised Signatory database to allow it to be updated and this is planned during Q4. Proposed revised due date: 31/03/2019	Finance and Integrated Service Support	David Gladwin
IA.FRAR20 17.15	A further review of petty cash imprest levels should be undertaken to ensure that the level is appropriate for the usage. Given the infrequency of petty cash claims by high schools, consideration should be given to reducing the imprest levels.	30-Jun-2018		67%	Q3 18/19: Off Target Further analysis on Children's Services petty cash usage completed. Engagement with all imprest holders with view to reducing balances will take place in Q4. Proposed revised due date: 31/03/2019	Finance and Integrated Service Support	Mike O'Rourke

2018 - Treasury Management - Good Assurance Rating

Action Code	Action	Due Date	Icon	Progress	Notes	Service	Managed By
IA.TREAS M.02	The risks associated with Treasury Management should be recorded on the Council's Risk Management system to allow reporting of the risks as part of the Council's overall risk management reporting to Management, Council and the Audit Committee.	30-Sep-2018		50%	<p>Q3 18/19: Off Target</p> <p>Meeting with Risk Manager has taken place and Risk Register Template received. TM Risks already recorded in TMPs and will be input into template and uploaded to Pentana.</p> <p>Will be completed during January 2019.</p> <p>Proposed revised due date: 31/03/2019</p>	Finance and Integrated Service Support	David Gladwin

Treasury Management and Investment Strategy 2019/20 & Prudential Indicators**Report by Gary Fairley, Head of Finance and Integrated Service Support****Covering Report****1 Purpose of Report**

A draft of the Treasury Management and Investment Strategy 2019/20 & Prudential Indicators report is being presented today to Audit Committee.

The report is presented in draft and subject to ongoing work on the Loans Fund Review. In addition, any comments on this report from Audit Committee shall be included in the final report to Council.

The purpose of the report is to seek the agreement of Council to the Treasury Management and Annual Investment Strategies for 2019/20 and the Prudential and Treasury indicators contained therein.

2 Background

The CIPFA Treasury Management Code of Practice 2017 requires that all Treasury Management reports are presented to an appropriate body for adequate scrutiny prior to being presented to full Council for approval. For Midlothian Council, this body is Audit Committee.

3 Report Implications

There are no direct resource implications arising from this report

4 Recommendations

The Audit Committee is invited to comment on this draft report before the final report is presented to Council.

Date 21 January 2019

Report Contact:

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Treasury Management and Investment Strategy 2019/20 & Prudential Indicators

Report by Gary Fairley, Head of Finance and Integrated Service Support

1 Purpose of Report

The purpose of the report is to seek the agreement of Council to the Treasury Management and Annual Investment Strategies for 2019/20 and the Prudential and Treasury indicators contained therein.

2 Treasury Management & Investment Strategy 2019/20

2.1 Current Loan and Investment Portfolio

The Council's current loan and investment portfolio, as at 11 January 2019, is shown in tables 1 and 2 below:-

Table 1: Current Loan Portfolio as at 11 January 2019

Loan Type	Principal Outstanding £000's	Weighted Average Rate
PWLB Annuity	674	8.90%
PWLB Maturity	187,224	3.73%
LOBO	20,000	4.51%
Forward Starting Loans	19,643	2.68%
Temporary Market Loans	2,500	0.65%
Salix Loans	794	0.00%
Total Loans	230,835	3.68%

Table 2: Current Investment Portfolio as at 11 January 2019

Investment Type	Principal Outstanding £000's	Weighted Average Rate
Bank Call Accounts	0	n/a
Money Market Funds	9,379	0.77%
Bank Notice Accounts	49,985	0.95%
Other Local Authorities	15,000	1.00%
Total Investments	74,364	0.93%

2.2 Borrowing Requirement 2018/19 to 2022/23

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

The projected borrowing requirement arising from the Council's Capital Plans, and the maturing long-term loans that require to be refinanced, over the period 2018/19 to 2022/23 is shown in table 3 below:-

Table 3: Total Borrowing Requirement over the period 2018/19 to 2022/23

	2018/19 £000's	2019/20 £000's	2020/21 £000's	2021/22 £000's	2022/23 £000's	Total £000's
Capital Expenditure						
General Services	29,713	75,067	51,015	30,931	16,507	203,232
HRA	14,738	54,519	92,286	51,698	20,244	233,485
Total Capital Expenditure	44,451	129,586	143,301	82,629	36,751	436,717
Total Available Financing	-32,454	-36,116	-49,330	-28,602	-23,151	-169,653
Principal Debt Repayments	-8,337	-8,390	-10,487	-11,922	-13,063	-52,199
Capital Expenditure less available Financing	3,660	85,080	83,484	42,105	536	214,865
Maturing Long-term Loans	10,452	9,201	9,282	1,534	1,554	32,023
Total Borrowing Requirement	14,112	94,281	92,766	43,639	2,090	246,888
Borrowing secured	-10,000	0	0	0	0	-10,000
Total Remaining Borrowing Requirement	4,112	94,281	92,766	43,639	2,090	236,888

2.3 Borrowing Strategy for remainder of 2018/19 and 2019/20

The current low Bank of England base rate level of 0.75% and the expectation that any base rate rises will follow a shallow upward trajectory in the short-medium term, means that continued utilisation of temporary borrowing within the Council's overall loan portfolio would continue to provide a cost-effective solution to the Council. The quantum of this will continue to be assessed against the backdrop of potential long term costs if the opportunity is missed to take PWLB loans at historically low medium-long term rates, particularly given the projected gradual rise in PWLB rates.

Long-term borrowing rates from the Debt Management Office's (DMO) Public Works Loans Board (PWLB) are currently sitting at, or close to, historical lows. Whilst the Council has already secured long-term borrowing for financial year 2018/19, as can be noted from Table 3 above the Council has a significant borrowing requirement across the forthcoming 4 financial years (2019/20 to 2022/23).

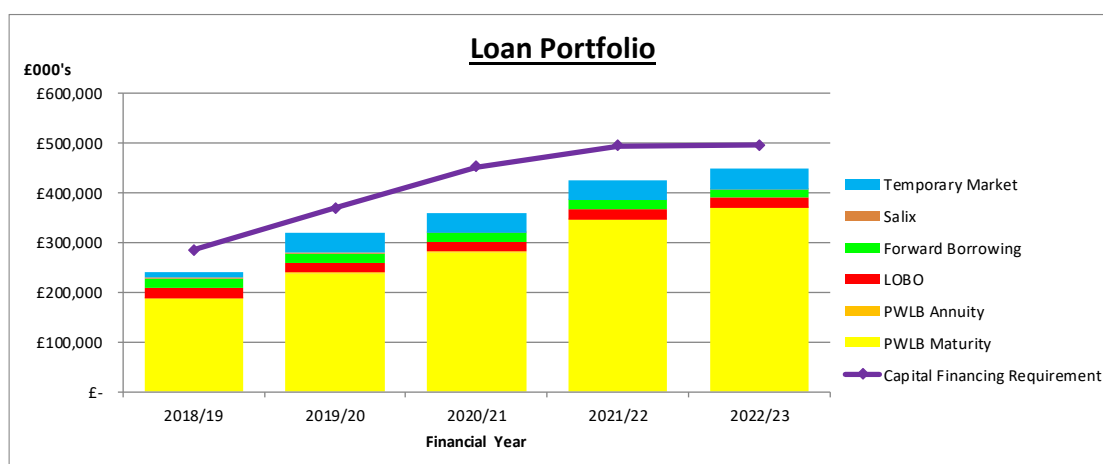
Part of this borrowing requirement has already been secured through the Council's two forward dealt loans. These involved the Council committing to draw down two £10 million loans at fixed interest rates that were priced against historically low borrowing rates, with minimal cost of carry and allowed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

It is expected that the majority of the remaining borrowing requirement to fund capital expenditure incurred in 2019/20 and 2020/21 shall be sourced from a blend of internal borrowing, further temporary borrowing and by locking in to longer term PWLB borrowing to manage longer term risk for the loan portfolio. However, the opportunity continues to exist to consider further loans on a 'forward dealing' basis, and officers will continue to explore the viability of these loans throughout the remainder of 2018/19 and into 2019/20.

Officers will ensure that any loans taken are drawn to match the existing maturity and projected capital expenditure profiles as closely as possible, that proposed interest rates continue to sit below forward interest rate projections, and that the overall borrowing remains within the Authorised Limit of £523.188 million proposed below.

Any other borrowing undertaken in advance of need 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.

The Council's projected loan portfolio over the period 2018/19 to 2022/23 is shown in graphical format below.



2.3 Investment Strategy

The position on potential investment opportunities remains broadly as reported to Council in the Treasury Management Mid-Year Update report on 13 November 2018.

The investment environment within which the Council seeks to invest its cash reserves remains challenging, with the continued scrutiny over the creditworthiness of counterparties resulting in an ever tighter counterparty list. At the same time, the low 0.75% Bank of England base rate dictates low returns of typically c. 1% for a 12 month fixed term deposit.

The Council currently has £64.985 million of investments with the following counterparties, which have the primary aim of cash backing the Council's reserves:-

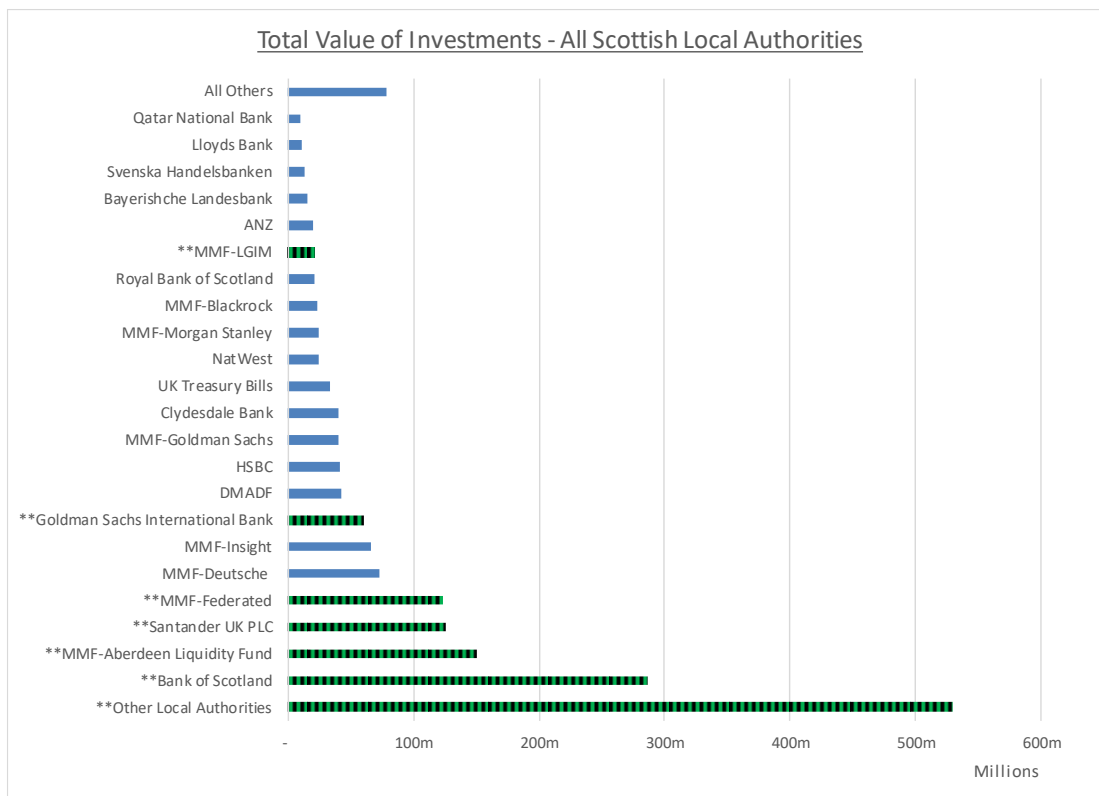
Counterparty	Amount £000's	Product	Security Long/Short Term Rating* (Colour)**	Liquidity	Yield
Bank of Scotland PLC	20,000	Notice account	A+/F1 (Orange)	175 days' notice	1.00%
Goldman Sachs International Bank	15,000	Notice account	A/F1 (Red)	185 days' notice	0.72%
Santander UK PLC	14,985	Notice account	A+/F1 (Red)	180 days' notice	1.10%
Warrington Borough Council	10,000	Fixed term deposit	n/a	Start: 21/03/18 Maturity 23/03/20	1.00% Year 1 / 1.70% Year 2
Plymouth City Council	5,000	Fixed term deposit	n/a	Start: 28/03/18 Maturity 30/03/20	1.00% Year 1 / 1.70% Year 2
Total	64,985				1.04%

* Credit Rating from Fitch

** Colour represents maximum recommended duration for investment per Link Asset Services, Treasury Solutions Credit Scoring methodology – see Appendix 1.

In addition, the Council currently holds £9.379 million in instant access accounts with Money Market Funds, earning a return as at the date of writing of 0.77%. These investments have the primary purpose of ensuring short-term liquidity for the Council in order to manage its day-to-day cashflow needs.

Attached below is a graph showing the total level of investments held by 31 of the 32 Local Authorities in Scotland. Counterparties that the Council currently have investments with are shown as a hatched bar and with a star next to the counterparty name.



Council officers, in conjunction with Link Asset Services, Treasury Solutions will continue to review the range of investment options available to the Council, within the proposed Permitted Investments included as Appendix 1, in order to select only the most creditworthy counterparties to ensure the security of Council funds, and from that list select the range of investment products that offer best value to the Council's investment portfolio.

An alternative investment strategy would be to deposit funds directly with the UK Government's Debt Management Account Deposit Facility (DMADF). All deposits with the UK DMADF would be guaranteed by HM Government and therefore have a direct claim on HM Government / the equivalent of a sovereign double-A credit rating.

Rates payable by the DMADF range from 0.50% for an overnight deposit to 0.51% for a 6 month deposit.

Were the Council to switch the entirety of its £64.985 million deposits that are currently invested with other counterparties into DMADF 6 month deposits, this would result in a loss of income to the Council of £0.344 million per annum.

3 Prudential Indicators

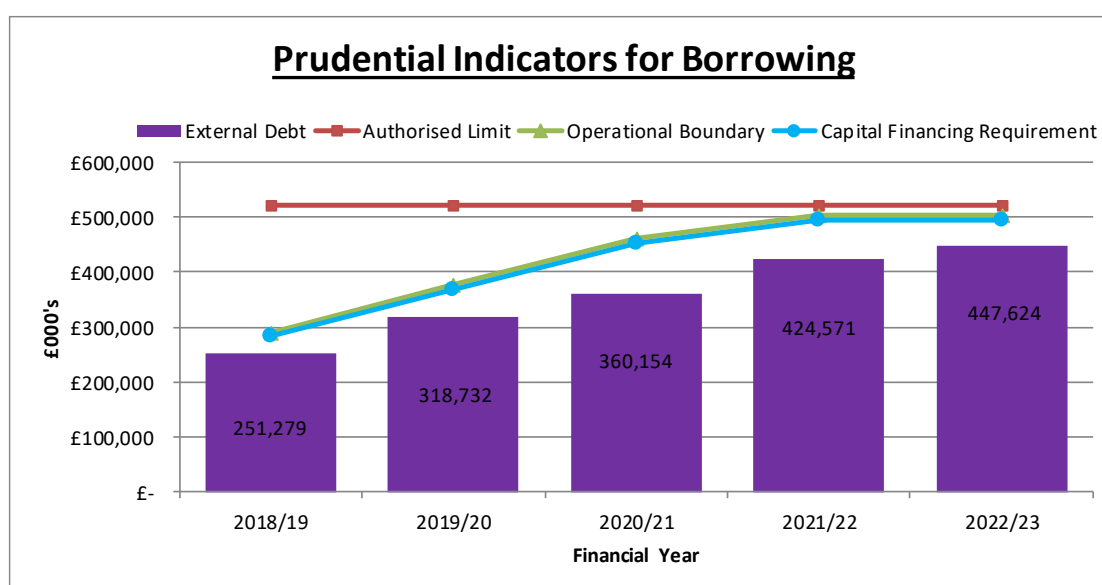
Prudential Code for Capital Finance in Local Authorities

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

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

- Original indicators and actual outcomes for 2017/18;
- Revised estimates of the 2018/19 indicators; and
- Estimates of indicators for 2019/20 to 2022/23.

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



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

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

The Authorised Limit for Borrowing has been calculated by taking the maximum value of the CFR over this year and the next 4 financial years (2019/20 to 2022/23), with the total forecast level of capital receipts and developer contributions added back to this figure (given the inherent uncertainty regarding the timing and value of these receipts/contributions). This is shown in table 4 below.

Table 4: Authorised Limit for Borrowing: Calculation

Authorised Limit	Amount £000's
CFR – General Services (31 March 2022)	168,552
CFR – HRA (31 March 2023)	328,252
Unrealised Capital Receipts & Developer Contributions 2018/19	218
Forecast level of Capital Receipts & Developer Contributions 2019/20 to 2022/23	26,166
Proposed Authorised Limit	523,188

Council is therefore asked to approve an adjustment to the authorised limit for borrowing to £523.188 million, if market conditions support this action. This would have the effect of securing lower costs for future years but care would be taken to ensure that the cost of carry from borrowing early is minimised and that the maturity structure of all debt is sufficiently robust to ensure that the CFR at 31 March 2023 remains achievable.

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

Statutory repayment of loans fund advances

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

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

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

A review of the Loans Fund accounting arrangements is currently being undertaken which includes an assessment of the period over which Loans Fund advances are projected to be repaid. The final outcome of the review is expected to be presented to Council for approval and reflected in the final Treasury Management & Annual Investment Strategy and 2019/20 Financial Strategy / Revenue Budget reports presented to Council on 12 February 2019.

Capital Strategy

The 2017 Prudential Code introduced a new requirement for local authorities to produce an annual capital strategy, which is a high level corporate document dealing with the key areas of strategic context, corporate priorities, capital investment ambition, available resources, affordability, capacity to deliver, risk appetite, risk management, and determining an appropriate split between non-financial, treasury management and commercial investments in the context of ensuring the long term financial sustainability of the authority, in appropriate detail so that members can properly assess the particular risks in this area.

4. Report Implications

4.1 Resources

There are no direct resource implications arising from this report.

4.2 Risk

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

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

4.3 Single Midlothian Plan and Business Transformation

Themes addressed in this report:

- ☐ Community safety
- ☐ Adult health, care and housing
- ☐ Getting it right for every Midlothian child
- ☐ Improving opportunities in Midlothian
- ☐ Sustainable growth
- ☐ Business transformation and Best Value
- ☒ None of the above

4.4 Impact on Performance and Outcomes

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

4.5 Adopting a Preventative Approach

The proposals in this report do not directly impact on the adoption of a preventative approach.

4.6 Involving Communities and Other Stakeholders

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

4.7 Ensuring Equalities

There are no equality issues arising from this report.

4.8 Supporting Sustainable Development

There are no sustainability issues arising from this report.

4.9 Digital Issues

There are no IT issues arising from this report.

5 Summary

The Treasury Management and Investment Strategies outlined in this document, and in the detailed document that has been placed in the Member's Library / uploaded to the Council's Committee Management System, have been formulated to comply with the revised Codes of Practice and relevant Regulations and provide the framework for achieving best value in the management of the Council's borrowing and investment portfolios.

6 Recommendations

It is recommended that the Council:-

- a) Approve the Treasury Management and Investment Strategy for the 2019/20 financial year, as detailed in Section 2 of this report;
- b) Approve the list of Permitted Investments outlined in Appendix 1;
- c) Adopt the Prudential Indicators contained in Appendix 2 of this report;
- d) Approve an adjustment to the Authorised Limit for Borrowing to £523.188 million (as shown in Section 3) if market conditions indicate that this is prudent;
- e) Note that the policy to repay loans fund advances made before 1 April 2016 will be to continue to use the 'Statutory annuity method';
- f) Note that the policy for the statutory repayment of loans fund advances made from 1 April 2016 will be to continue to use the 'Statutory annuity method' and that the current annuity rate applied is 3.10%;

- g) Note that work is continuing to take place regarding the Loans Fund Review and that an update to the 'Treasury Management and Investment Strategy 2019/20 & Prudential Indicators' will be presented in due course if required.

Date:- 18 January 2019

Report Contact:-

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Tel No 0131 271 3230

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Background Papers:-

Appendix 1:- Permitted Investments

Appendix 2:- Prudential Indicators

Appendix 3:- Treasury Management & Annual Investment Strategy
Statement – 2019/20 Detailed – uploaded to Members Library
on the Committee Management System

Permitted Investments

Appendix 1

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

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

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

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

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

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

Note that the maximum suggested durations listed above have been extended by 1 year (when compared to the suggested maximum durations provided by 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, and the maximum duration for the Green category has been extended by 20 days to 120 days, on the same basis. A thorough appraisal of the additional risk involved in extending the duration of any deposit (marginally) beyond the maximum suggested by Capita, against any enhanced value to the portfolio, will be undertaken prior to the placement of any deposit.

1.1 Deposits

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

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

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

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

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

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

1.4 Securities issued or guaranteed by governments

Investment Category	* Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period
Treasury Bills	UK sovereign rating	Sale T+1	Yes	100%	50 years
UK Government Gilts	UK sovereign rating	Sale T+1	Yes	100%	50 years
Bond issuance issued by a financial institution which is explicitly guaranteed by the UK Government e.g. National Rail	UK sovereign rating	Sale T+3	Yes	100%	50 years
Sovereign bond issues (other than the UK govt)	AAA (or state your criteria if different)	Sale T+1	Yes	100%	50 years
Bonds issued by multilateral development banks	AAA (or state your criteria if different)	Sale T+1	Yes	10)%	50 years

1.5 Securities issued by corporate organisations

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

1.6 Other

Investment Category	Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period
Local authority mortgage guarantee scheme.	Blue	Term	No	50%	5 years
Loans to Third Parties	n/a	Term	No	£25m	20 years
Subordinated Debt Subscription to Newbattle Centre SPV	n/a	Term	No	£0.5m	27 years
Property Funds	n/a	T+4	Yes	50%	15 years

1. Prudential Indicators for Affordability

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

1.1 Estimates of Ratio of Financing Costs to Net Revenue Stream

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

Ratio of Financing Costs to Net Revenue Stream							
%	2017/18	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
	Original	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
General Services	3.78%	3.17%	2.86%	3.04%	3.23%	3.33%	3.43%
HRA	34.14%	36.34%	37.26%	38.79%	45.31%	47.96%	52.10%

The figures above are based on the latest Capital Plans presented to Council.

1.2 HRA Ratios

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

Table 6: HRA Debt as a % of Gross Revenue							
	2017/18	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
	Estimate	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
HRA debt £000's	£ 166,325	£ 163,857	£ 169,011	£ 213,062	£ 285,120	£ 326,047	£ 328,252
HRA revenues £000's	£ 26,399	£ 27,798	£ 27,945	£ 29,610	£ 31,080	£ 33,670	£ 35,538
Ratio of debt to revenues %	630%	589%	605%	720%	917%	968%	924%

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

Table 7: HRA Debt per Dwelling							
	2017/18	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
	Estimate	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
HRA debt £000's	£ 166,325	£ 163,857	£ 169,011	£ 213,062	£ 285,120	£ 326,047	£ 328,252
Number of HRA dwellings	6,917	6,985	6,907	6,962	7,194	7,528	7,839
Debt per dwelling £	£ 24,046	£ 23,458	£ 24,470	£ 30,604	£ 39,633	£ 43,311	4187%

2. Prudential Indicators for Capital Expenditure

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

2.1 Estimated Capital Expenditure

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

Capital Expenditure						
	2017/18 Actual £000's	2018/19 Estimate £000's	2019/20 Estimate £000's	2020/21 Estimate £000's	2021/22 Estimate £000's	2022/23 Estimate £000's
General Services						
Resources	£ 8,127	£ 11,930	£ 20,874	£ 17,336	£ 12,478	£ 16,111
Education, Community & Economy	£ 8,647	£ 17,617	£ 46,516	£ 22,103	£ 9,196	£ 751
Health & Social Care	£ 170	£ 504	£ 8,416	£ 2,760	£ 397	£ 178
Business Transformation	£ 39	£ 35	£ 4	£ 10,692	£ 10,135	£ 240
Provision for Return of Contingencies	£ -	£ (372)	£ (743)	£ (1,877)	£ (1,275)	£ (773)
Total General Services	£ 16,984	£ 29,713	£ 75,067	£ 51,015	£ 30,931	£ 16,507
Total HRA	£ 10,572	£ 14,738	£ 54,519	£ 92,286	£ 51,698	£ 20,244
Combined Total	£ 27,556	£ 44,451	£ 129,586	£ 143,301	£ 82,629	£ 36,751

2.2 Financing of Capital Expenditure

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

Capital Expenditure and Available Financing					
	2018/19	2019/20	2020/21	2021/22	2022/23
	Estimate	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's
Capital Expenditure					
General Services	£ 29,713	£ 75,067	£ 51,015	£ 30,931	£ 16,507
HRA	£ 14,738	£ 54,519	£ 92,286	£ 51,698	£ 20,244
Total	£ 44,451	£ 129,586	£ 143,301	£ 82,629	£ 36,751
Financed by:					
Capital receipts	£ 253	£ 900	£ 1,100	£ -	£ -
Capital grants	£ 20,339	£ 23,978	£ 36,606	£ 13,596	£ 18,784
Capital reserves	£ 750	£ 1,687	£ 2,000	£ 10,694	£ 2,000
Developer/Other Contributions	£ 11,112	£ 9,551	£ 9,624	£ 4,311	£ 2,367
Net financing need for the year	£ 11,997	£ 93,470	£ 93,971	£ 54,027	£ 13,599

2.3 Estimated Capital Financing Requirement

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

Capital Financing Requirement (CFR)						
	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's	£000's
Capital Financing Requirement						
CFR – General Services	£ 116,145	£ 114,919	£ 155,947	£ 167,374	£ 168,552	£ 166,883
CFR – HRA	£ 164,124	£ 169,011	£ 213,062	£ 285,120	£ 326,047	£ 328,252
CFR – PFI Schemes	£ 53,659	£ 52,233	£ 50,683	£ 48,998	£ 47,167	£ 47,168
Total CFR	£ 333,929	£ 336,163	£ 419,692	£ 501,492	£ 541,766	£ 542,303
Movement in CFR	£ 175	£ 2,234	£ 83,530	£ 81,799	£ 40,274	£ 537
Movement in CFR represented by						
Net financing need for the year (previous table)	£ 9,457	£ 11,997	£ 93,470	£ 93,971	£ 54,027	£ 13,599
Less Scheduled Debt Amortisation	£ (7,969)	£ (8,337)	£ (8,390)	£ (10,487)	£ (11,922)	£ (13,063)
Less PFI Finance Lease Principal Payments	£ (1,313)	£ (1,426)	£ (1,550)	£ (1,685)	£ (1,831)	£ 1
Movement in CFR	£ 175	£ 2,234	£ 83,530	£ 81,799	£ 40,274	£ 537

3. Prudential Indicators for Prudence

3.1 Net Borrowing Requirement

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

Net Borrowing Requirement						
	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's	£000's
External Debt						
Debt at 1 April	£ 257,302	£ 241,031	£ 251,279	£ 318,732	£ 360,154	£ 424,571
Actual/Expected change in Debt	£ (16,271)	£ 10,248	£ 67,453	£ 41,422	£ 29,101	£ 23,053
Other long-term liabilities (OLTL)	£ 54,972	£ 53,659	£ 52,233	£ 50,683	£ 48,998	£ 47,167
Actual/Expected change in OLTL	£ (1,313)	£ (1,426)	£ (1,550)	£ (1,685)	£ (1,832)	£ (1,831)
Actual/Expected Gross Debt at 31 March	£ 294,690	£ 303,512	£ 369,415	£ 409,152	£ 436,421	£ 492,960
The Capital Financing Requirement	£ 333,929	£ 336,163	£ 419,692	£ 501,492	£ 541,766	£ 542,303
Under / (over) borrowing	£ 39,239	£ 32,651	£ 50,277	£ 92,340	£ 105,345	£ 49,343
Investments						
Cash & Cash Equivalents	£ 10,000	£ 10,000	£ 10,000	£ 10,000	£ 10,000	£ 10,000
Short-Term Investments	£ 64,985	£ 64,985	£ 64,985	£ 64,985	£ 64,985	£ 64,985
Total Investments	£ 74,985	£ 74,985	£ 74,985	£ 74,985	£ 74,985	£ 74,985

4. Prudential Indicators for External Debt

4.1 Operational Boundary

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

For this Council:-

- the Operational Boundary for Borrowing has been calculated to equate directly to the value of the CFR for General Services and HRA combined, over the current financial year and the following 4 financial years (2018/19 to 2022/23); and
- the Operational Boundary for Other Long-Term Liabilities has been calculated to equate directly to the in-year CFR for Other Long-Term Liabilities, given the known contractual provisions for the repayment of debt within the Council's two PPP agreements.

Operational Boundary						
	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's	£000's
Operational Boundary - Borrowing	£280,270	£283,930	£369,009	£452,494	£494,599	£495,135
Operational Boundary - Other long term liabilities	£53,659	£52,233	£50,683	£48,998	£47,167	£47,168
Total	£333,929	£336,163	£419,692	£501,492	£541,766	£542,303

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

4.2 Authorised Limit of Total External Debt

This indicator sets the limit for total external debt.

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

In order to continue to service the ongoing external debt and finance the current capital programmes the Council needs to increase its external borrowing to £523.188 million by 31 March 2023. Within the Capital Plans, there are assumptions regarding capital receipts and developer contributions which when applied to the Council's capital plans reduce the Council's borrowing requirements. However, the realisation of these capital receipts and developer contributions carry inherent uncertainty around both the timing and value of each receipt/contribution, given that they are largely dependent upon economic and market activity which are outwith the Council's control. Therefore, in order to calculate the Authorised Limit for Borrowing, these capital receipts and developer contributions have been added to the Capital Financing Requirement, to give the Council flexibility to fully borrow in advance of need (if market conditions support this action) should these receipts and contributions be unable to be realised in the short term. This therefore reflects a level of borrowing which, while not desired, could be afforded but is not sustainable.

Council is therefore asked to approve that, rather than restrict borrowing to £283.930 million for 2018/19, £369.009 million for 2019/20, £452.494 million for 2020/21, £494.599 million for 2021/22 and £495.135 million for 2022/23, that permission be granted to borrow up to the 2022/23 Authorised Limit for borrowing of £495.135 million as shown in the table below), if market conditions support this action.

Adopting this approach will secure lower costs for future years but care will be taken to ensure that the cost of carry is minimised and that the maturity structure of all debt is sufficiently robust to ensure that the Capital Financing Requirement at 31 March 2023 remains achievable.

	Authorised Limit					
	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's	£000's
Authorised Limit - Borrowing	£ 523,188	£ 523,188	£ 523,188	£ 523,188	£ 523,188	£ 523,188
Authorised Limit - Other long term liabilities	£ 53,659	£ 52,233	£ 50,683	£ 48,998	£ 47,167	£ 47,168
Total Debt	£ 576,847	£ 575,421	£ 573,871	£ 572,186	£ 570,355	£ 570,356

Reconciliation of calculation of Authorised Limit for borrowing:-

Reconciliation of Authorised Limit for Borrowing	
	£000's
CFR - General Services at 31 March 2021	£ 168,552
CFR - HRA at 31 March 2022	£ 328,252
Capital Receipts 2018/19 unrealised to date	£ -
Capital Receipts 2019/20 to 2022/23	£ 2,000
Developer/Other Contributions 2018/19 Unrealised to date	£ 218
Developer/Other Contributions 2019/20 to 2022/23	£ 24,166
Authorised Limit for Borrowing	£ 523,188

5. Prudential Indicators for Treasury Management

5.1 Upper limits on Fixed and Variable Interest Rates

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

Upper Limits on Exposure to Fixed and Variable Interest Rates 2019/20			
Interest rate exposures			Upper Limit
Limits on fixed interest rates based on gross debt			100.00%
Limits on variable interest rates based on gross debt			30.00%
Limits on fixed interest rates based on investments			100.00%
Limits on variable interest rates based on investments			100.00%

5.2 Maturity Structure of Borrowing

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

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

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

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

Maturity Structure of Borrowing 2019/20		
Maturity structure of fixed interest rate borrowing 2019/20	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 2019/20	Lower	Upper
<i>Under 12 months</i>	0.00%	30.00%
<i>12 months to 2 years</i>	0.00%	30.00%
<i>2 years to 5 years</i>	0.00%	30.00%
<i>5 years to 10 years</i>	0.00%	30.00%
<i>10 years to 20 years</i>	0.00%	30.00%
<i>20 years to 30 years</i>	0.00%	30.00%
<i>30 years to 40 years</i>	0.00%	30.00%
<i>40 years to 50 years</i>	0.00%	30.00%
<i>50 years and above</i>	0.00%	30.00%

5.4 Total Principal Sums Invested for Periods Longer than 365 Days

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

Principal Sums Invested for > 365 Days		
Limit		£70m

The current strategy as outlined in the body of these reports is to cash-back the Council's balance sheet reserves. It is expected that the majority of this will be in the form of 12 month fixed term deposits and/or certificates of deposit; however the Council currently have two fixed term deposits with other Local Authorities, with an original maturity period of 2 years, which offer security of funds along with a higher yield as a result of longer duration. With this in mind, the limit for principal sums invested for > 365 days has therefore been set at £70m to give the Council flexibility to extend the duration of deposits that are cash-backing the Council's reserves.

Treasury Management Strategy Statement and Annual Investment Strategy

Midlothian Council
2019/20

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1 INTRODUCTION

1.1 Background

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

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

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

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

CIPFA defines treasury management as:

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

Revised reporting is required for the 2019/20 reporting cycle due to revisions of the CIPFA Prudential Code and the CIPFA Treasury Management Code. The primary reporting changes include the introduction of a capital strategy, to provide a longer-term focus to the capital plans, and greater reporting requirements surrounding any commercial activity if that is going to be undertaken.

1.2 Reporting requirements

1.2.1 Capital Strategy

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

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

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

1.2.2 Treasury Management Reporting

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

- a) **Prudential and treasury indicators and treasury strategy** (this report) - The first, and most important report covers:
 - the capital plans (including prudential indicators) for 2019/20 to 2022/23;
 - 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 2019/20, including treasury indicators; and
 - a permitted investment strategy for 2019/20 (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 on 29 January 2019 prior to consideration by Council on 12 February 2019.

1.3 Treasury Management Strategy for 2019/20

The strategy for 2019/20 covers two main areas:

Capital issues

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

Treasury management issues

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

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

1.4 Training

The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsible for scrutiny. A training workshop for Members was held on 14 June 2017 and further training will be arranged as required.

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

1.5 Treasury management consultants

The Council uses Link Asset Services, 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 2019/20 – 2022/23

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

2.1 Capital expenditure

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

The table below summarises the Capital Expenditure forecasts:-

Table 1: Capital Expenditure						
	2017/18 Actual £000's	2018/19 Estimate £000's	2019/20 Estimate £000's	2020/21 Estimate £000's	2021/22 Estimate £000's	2022/23 Estimate £000's
General Services						
Resources	£ 8,127	£ 11,930	£ 20,874	£ 17,336	£ 12,478	£ 16,111
Education, Community & Economy	£ 8,647	£ 17,617	£ 46,516	£ 22,103	£ 9,196	£ 751
Health & Social Care	£ 170	£ 504	£ 8,416	£ 2,760	£ 397	£ 178
Business Transformation	£ 39	£ 35	£ 4	£ 10,692	£ 10,135	£ 240
Provision for Return of Contingencies	£ -	£ (372)	£ (743)	£ (1,877)	£ (1,275)	£ (773)
Total General Services	£ 16,984	£ 29,713	£ 75,067	£ 51,015	£ 30,931	£ 16,507
Total HRA	£ 10,572	£ 14,738	£ 54,519	£ 92,286	£ 51,698	£ 20,244
Combined Total	£ 27,556	£ 44,451	£ 129,586	£ 143,301	£ 82,629	£ 36,751

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					
	2018/19 Estimate £000's	2019/20 Estimate £000's	2020/21 Estimate £000's	2021/22 Estimate £000's	2022/23 Estimate £000's
Capital Expenditure					
General Services	£ 29,713	£ 75,067	£ 51,015	£ 30,931	£ 16,507
HRA	£ 14,738	£ 54,519	£ 92,286	£ 51,698	£ 20,244
Total	£ 44,451	£ 129,586	£ 143,301	£ 82,629	£ 36,751
Financed by:					
Capital receipts	£ 253	£ 900	£ 1,100	£ -	£ -
Capital grants	£ 20,339	£ 23,978	£ 36,606	£ 13,596	£ 18,784
Capital reserves	£ 750	£ 1,687	£ 2,000	£ 10,694	£ 2,000
Developer/Other Contributions	£ 11,112	£ 9,551	£ 9,624	£ 4,311	£ 2,367
Net financing need for the year	£ 11,997	£ 93,470	£ 93,971	£ 54,027	£ 13,599

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)						
	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's	£000's
Capital Financing Requirement						
CFR – General Services	£ 116,145	£ 114,919	£ 155,947	£ 167,374	£ 168,552	£ 166,883
CFR – HRA	£ 164,124	£ 169,011	£ 213,062	£ 285,120	£ 326,047	£ 328,252
CFR – PFI Schemes	£ 53,659	£ 52,233	£ 50,683	£ 48,998	£ 47,167	£ 47,168
Total CFR	£ 333,929	£ 336,163	£ 419,692	£ 501,492	£ 541,766	£ 542,303
Movement in CFR	£ 175	£ 2,234	£ 83,530	£ 81,799	£ 40,274	£ 537
Movement in CFR represented by						
Net financing need for the year (previous table)	£ 9,457	£ 11,997	£ 93,470	£ 93,971	£ 54,027	£ 13,599
Less Scheduled Debt Amortisation	£ (7,969)	£ (8,337)	£ (8,390)	£ (10,487)	£ (11,922)	£ (13,063)
Less PFI Finance Lease Principal Payments	£ (1,313)	£ (1,426)	£ (1,550)	£ (1,685)	£ (1,831)	£ 1
Movement in CFR	£ 175	£ 2,234	£ 83,530	£ 81,799	£ 40,274	£ 537

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.

Table 4: Balance Sheet Resources						
Reserve	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's	£000's
HRA Balances	£ 33,863	£ 38,615	£ 43,005	£ 45,253	£ 46,604	£ 46,604
General Fund Balances	£ 2,926	£ 3,033	£ 3,033	£ 3,033	£ 3,033	£ 3,033
Earmarked reserves	£ 7,851	£ 790	£ -	£ -	£ -	£ -
Provisions	£ 2,889	£ 2,772	£ 3,236	£ 3,214	£ 2,787	£ 2,787
Capital Fund	£ 19,462	£ 22,535	£ 26,113	£ 24,113	£ 20,559	£ 18,559
Total Reserves / Core Funds	£ 66,991	£ 67,745	£ 75,387	£ 75,613	£ 72,983	£ 70,983

2.4 Statutory repayment of loans fund advances

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

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

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

A review of the Loans Fund accounting arrangements is currently being undertaken which includes an assessment of the period over which Loans Fund advances are projected to be repaid. The final outcome of the review is expected to be presented to Council for approval and reflected in the final Treasury Management & Annual Investment Strategy and 2019/20 Financial Strategy / Revenue Budget reports presented to Council on 12 February 2019.

3 Borrowing

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

3.1 Current portfolio position

The overall treasury management portfolio as at 31 March 2018 and for the position as at 11 January 2019 are shown below for both borrowing and investments.

Loan Type	31 March 2018		11 January 2019	
	Principal Outstanding £000's	Weighted Average Rate	Principal Outstanding £000's	Weighted Average Rate
PWLB Annuity	708	8.90%	674	8.90%
PWLB Maturity	197,224	3.72%	187,224	3.73%
LOBO	20,000	4.51%	20,000	4.51%
Forward Starting Loans	9,821	2.63%	19,643	2.68%
Temporary Market Loans	13,000	0.58%	2,500	0.65%
Salix Loans	277	0.00%	794	0.00%
Total Loans	241,030	3.47%	230,835	3.68%

Investment Type	31 March 2018		11 January 2019	
	Principal Outstanding £000's	Weighted Average Rate	Principal Outstanding £000's	Weighted Average Rate
Bank Call Accounts	-	n/a	-	n/a
Money Market Funds	8,026	0.46%	9,379	0.77%
Bank Notice Accounts	49,985	0.73%	49,985	0.95%
Other Local Authorities	15,000	1.00%	15,000	1.00%
Total Investments	58,011	0.76%	59,364	0.93%

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 8: Current Treasury Portfolio						
	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's	£000's
External Debt						
Debt at 1 April	£ 257,302	£ 241,031	£ 251,279	£ 318,732	£ 360,154	£ 424,571
Actual/Expected change in Debt	£ (16,271)	£ 10,248	£ 67,453	£ 41,422	£ 29,101	£ 23,053
Other long-term liabilities (OLTL) at 1 April	£ 54,972	£ 53,659	£ 52,233	£ 50,683	£ 48,998	£ 47,167
Actual/Expected change in OLTL	£ (1,313)	£ (1,426)	£ (1,550)	£ (1,685)	£ (1,832)	£ (1,831)
Actual/Expected Gross Debt at 31 March	£ 294,690	£ 303,512	£ 369,415	£ 409,152	£ 436,421	£ 492,960
The Capital Financing Requirement	£ 333,929	£ 336,163	£ 419,692	£ 501,492	£ 541,766	£ 542,303
Under / (over) borrowing	£ 39,239	£ 32,651	£ 50,277	£ 92,340	£ 105,345	£ 49,343
Investments						
Cash & Cash Equivalents	£ 10,000	£ 10,000	£ 10,000	£ 10,000	£ 10,000	£ 10,000
Short-Term Investments	£ 64,985	£ 64,985	£ 64,985	£ 64,985	£ 64,985	£ 64,985
Total Investments	£ 74,985	£ 74,985	£ 74,985	£ 74,985	£ 74,985	£ 74,985

Within the range of prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2019/20 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

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

3.2 Treasury Indicators: limits to borrowing activity

The operational boundary

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

For this Council:-

- the Operational Boundary for Borrowing has been calculated to equate directly to the in-year value of the CFR over the next 5 financial years (2019/20 to 2022/23); and
- the Operational Boundary for Other Long-Term Liabilities has been calculated to equate directly to the in-year CFR for Other Long-Term Liabilities, given the known contractual provisions for the repayment of debt within the Council's two PPP agreements.

Table 9: Operational Boundary						
	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's	£000's
Operational Boundary - Borrowing	£280,270	£283,930	£369,009	£452,494	£494,599	£495,135
Operational Boundary - Other long term liabilities	£53,659	£52,233	£50,683	£48,998	£47,167	£47,168
Total	£333,929	£336,163	£419,692	£501,492	£541,766	£542,303

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.

- 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;
- The Authorised Limit for Borrowing has been calculated by taking the maximum value of the CFR over the next 4 financial years (2019/20 to 2022/23), 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):-
 - Council is therefore asked to approve that, rather than restrict borrowing to £283.930 million for 2018/19, £369.009 million for 2019/20, £452.494 million for 2020/21, £494.599 million for 2021/22 and £495.135 million for 2022/23, that permission be granted to borrow up to the 2022/23 Authorised Limit for borrowing of £495.135 million as shown in the table below), if market conditions support this action;
 - This would have the effect of securing lower costs for future years but care would be taken to ensure that the cost of carry from borrowing early is minimized and that the maturity structure of all debt is sufficiently robust to ensure that the CFR at 31 March 2023 remains achievable.
 - The authorised limit therefore reflects a level of borrowing which, while not desired, could be afforded but is not sustainable.
- The Authorised Limit for Other Long-Term Liabilities has been calculated to equate directly to the Operational Boundary for Other Long-Term Liabilities, given the known contractual provisions for the repayment of debt within the Council's two PPP agreements.

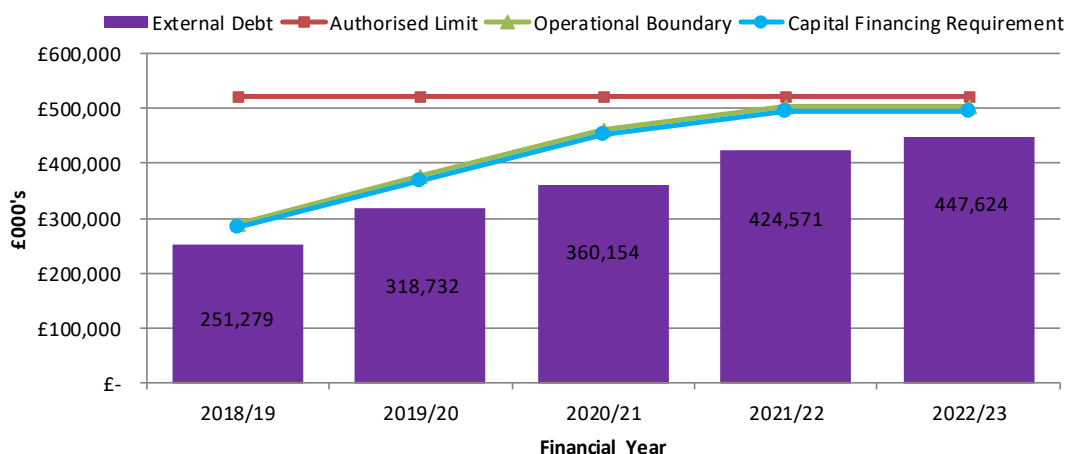
Table 10: Authorised Limit

	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's	£000's
Authorised Limit - Borrowing	£523,188	£523,188	£523,188	£523,188	£523,188	£523,188
Authorised Limit - Other long term liabilities	£53,659	£52,233	£50,683	£48,998	£47,167	£47,168
Total Debt	£576,847	£575,421	£573,871	£572,186	£570,355	£570,356

Table 11: Reconciliation of Authorised Limit for Borrowing

	£000's
CFR - General Services at 31 March 2021	£168,552
CFR - HRA at 31 March 2022	£328,252
Capital Receipts 2018/19 unrealised to date	£-
Capital Receipts 2019/20 to 2022/23	£2,000
Developer/Other Contributions 2018/19 Unrealised to date	£218
Developer/Other Contributions 2019/20 to 2022/23	£24,166
Authorised Limit for Borrowing	£523,188

Prudential Indicators for Borrowing



3.3 Prospects for interest rates

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

Table 12: Interest Rate Forecasts								
Quarterly Averages								
Quarter Ending	Bank Rate	3 Month LIBID	6 Month LIBID	12 Month LIBID	PWLB Borrowing Rates (inc. certainty rate adjustment)			
					5 year	10 year	25 year	50 year
Dec 2018	0.75%	0.80%	0.90%	1.10%	2.00%	2.50%	2.90%	2.70%
Mar 2019	0.75%	0.90%	1.00%	1.20%	2.10%	2.50%	2.90%	2.70%
Jun 2019	1.00%	1.00%	1.20%	1.30%	2.20%	2.60%	3.00%	2.80%
Sep 2019	1.00%	1.10%	1.30%	1.40%	2.20%	2.60%	3.10%	2.90%
Dec 2019	1.00%	1.20%	1.40%	1.50%	2.30%	2.70%	3.10%	2.90%
Mar 2020	1.25%	1.30%	1.50%	1.60%	2.30%	2.80%	3.20%	3.00%
Jun 2020	1.25%	1.40%	1.60%	1.70%	2.40%	2.90%	3.30%	3.10%
Sep 2020	1.25%	1.50%	1.70%	1.80%	2.50%	2.90%	3.30%	3.10%
Dec 2020	1.50%	1.50%	1.70%	1.90%	2.50%	3.00%	3.40%	3.20%
Mar 2021	1.50%	1.60%	1.80%	2.00%	2.60%	3.00%	3.40%	3.20%
Jun 2021	1.75%	1.70%	1.90%	2.10%	2.60%	3.10%	3.50%	3.30%
Sep 2021	1.75%	1.80%	2.00%	2.20%	2.70%	3.10%	3.50%	3.30%
Dec 2021	1.75%	1.90%	2.10%	2.30%	2.80%	3.20%	3.60%	3.40%
Mar 2022	2.00%	2.00%	2.20%	2.40%	2.80%	3.20%	3.60%	3.40%

The flow of generally positive economic statistics after the quarter ended 30 June meant that it came as no surprise that the MPC came to a decision on 2 August to make the first increase in Bank Rate above 0.5% since the financial crash, from 0.5% to 0.75%. Growth has been healthy since that meeting, but is expected to weaken somewhat during the last quarter of 2018. At their November meeting, the MPC left Bank Rate unchanged, but expressed some concern at the Chancellor's fiscal stimulus in his Budget, which could increase inflationary pressures. However, it is unlikely that the MPC would increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. The next increase in Bank Rate is therefore forecast to be in May 2019, followed by increases in February and November 2020, before ending up at 2.0% in February 2022.

The overall longer run future trend is for gilt yields, and consequently PWLB rates, to rise, albeit gently. However, over about the last 25 years, we have been through a period of falling bond yields as inflation subsided to, and then stabilised at, much lower levels than before, and supported by central banks implementing substantial quantitative easing purchases of government and other debt after the financial crash of 2008. Quantitative easing, conversely, also caused a rise in equity values as investors searched for higher returns and purchased riskier assets. In 2016, we saw the start of a reversal of this trend with a sharp rise in bond yields after the US Presidential election in November 2016, with yields then rising further as a result of the big increase in the US government deficit aimed at stimulating even stronger economic growth. That policy change also created concerns around a significant rise in inflationary pressures in an economy which was already running at remarkably low levels of unemployment. Unsurprisingly, the Fed has continued on its series of robust responses to combat its perception of rising inflationary pressures by repeatedly increasing the Fed rate to reach 2.00 – 2.25% in September 2018. It has also continued its policy of not fully reinvesting proceeds from bonds that it holds as a result of quantitative easing, when they mature. We have, therefore, seen US 10 year bond Treasury yields rise above 3.2% during October 2018 and also seen investors causing a sharp fall in equity prices as they sold out of holding riskier assets.

Rising bond yields in the US have also caused some upward pressure on bond yields in the UK and other developed economies. However, the degree of that upward pressure has been dampened by how strong or weak the prospects for economic growth and rising inflation are in each country, and on the degree of progress towards the reversal of monetary policy away from quantitative easing and other credit stimulus measures.

From time to time, gilt yields, and therefore PWLB rates, can be subject to exceptional levels of volatility due to geo-political, sovereign debt crisis, emerging market developments and sharp changes in investor sentiment. Such volatility could occur at any time during the forecast period.

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

Investment and borrowing rates

- Investment returns are likely to remain low during 2019/20 but to be on a gently rising trend over the next few years.
- Borrowing interest rates have been volatile so far in 2018-19 and have increased modestly since the summer. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in the future when authorities may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt;
- There will remain a cost of carry, (the difference between higher borrowing costs and lower investment returns), to any new long-term borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost.

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

3.4 Borrowing strategy

The Council is currently maintaining an under-borrowed (internally-borrowed) position (£39.2 million at the end of financial year 2017/18). This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is still an issue to be considered.

Against this background and the risks within the economic forecast, caution will be adopted with the 2019/20 treasury operations. The Head of Finance & Integrated Service Support will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

- *if it was felt that there was a significant risk of a sharp FALL in long and short term rates* (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered;
- *if it was felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast*, perhaps arising from an acceleration in the rate of increase in central rates in the USA and UK, an increase in world economic activity, or a sudden increase in inflation risks, then the portfolio position will be re-appraised. Most likely, fixed rate funding will be drawn whilst interest rates are lower than they are projected to be in the next few years.

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

The current low Bank of England base rate level of 0.75% and the expectation that any base rate rises will follow a shallow upward trajectory in the short-medium term, means that continued utilisation of temporary borrowing within the Council's overall loan portfolio would continue to provide a cost-effective solution to the Council. The quantum of this will continue to be assessed against the backdrop of potential long term costs if the opportunity is missed to take PWLB loans at historically low medium-long term rates, particularly given the projected gradual rise in PWLB rates.

Long-term borrowing rates from the Debt Management Office's (DMO) Public Works Loans Board (PWLB) are currently sitting at, or close to, historical lows. Whilst the Council has already secured long-term borrowing for financial year 2018/19, as can be noted from Table 3 above the Council has a significant borrowing requirement across the forthcoming 4 financial years (2019/20 to 2022/23).

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

It is expected that the majority of the remaining borrowing requirement to fund capital expenditure incurred in 2019/20 and 2020/21 shall be sourced from a blend of internal borrowing, further temporary borrowing and by locking in to longer term PWLB borrowing to manage longer term risk for the loan portfolio. However, the opportunity continues to exist to consider further loans on a 'forward dealing' basis, and officers will continue to explore the viability of these loans throughout the remainder of 2018/19 and into 2019/20.

Officers will ensure that any loans taken are drawn to match the existing maturity and projected capital expenditure profiles as closely as possible, that proposed interest rates continue to sit below forward interest rate projections, and that the overall borrowing remains within the Authorised Limit of £523.188 million proposed below.

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

Treasury management limits on activity

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

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

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

Table 13: Treasury Indicators & Limits			
	2018/19	2019/20	2020/21
Interest rate exposures	Upper	Upper	Upper
Limits on fixed interest rates based on gross debt	100.00%	100.00%	100.00%
Limits on variable interest rates based on gross debt	30.00%	30.00%	30.00%
Limits on fixed interest rates based on investments	100.00%	100.00%	100.00%
Limits on variable interest rates based on investments	100.00%	100.00%	100.00%
Maturity structure of fixed interest rate borrowing 2018/19	Lower	Upper	
Under 12 months	0.00%	50.00%	
12 months to 2 years	0.00%	50.00%	
2 years to 5 years	0.00%	50.00%	
5 years to 10 years	0.00%	50.00%	
10 years to 20 years	0.00%	50.00%	
20 years to 30 years	0.00%	50.00%	
30 years to 40 years	0.00%	50.00%	
40 years to 50 years	0.00%	50.00%	
50 years and above	0.00%	50.00%	
Maturity structure of variable interest rate borrowing 2018/19	Lower	Upper	
<i>Under 12 months</i>	0.00%	30.00%	
<i>12 months to 2 years</i>	0.00%	30.00%	
<i>2 years to 5 years</i>	0.00%	30.00%	
<i>5 years to 10 years</i>	0.00%	30.00%	
<i>10 years to 20 years</i>	0.00%	30.00%	
<i>20 years to 30 years</i>	0.00%	30.00%	
<i>30 years to 40 years</i>	0.00%	30.00%	
<i>40 years to 50 years</i>	0.00%	30.00%	
<i>50 years and above</i>	0.00%	30.00%	

3.5 Policy on borrowing in advance of need

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

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

3.6 Debt rescheduling

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

The reasons for any rescheduling to take place will include:

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

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

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

4 ANNUAL INVESTMENT STRATEGY

4.1 Investment policy

The Council's investment policy has regard to the Scottish Government's Local Government Investments (Scotland) Regulations 2010 (and accompanying Finance Circular 5/2010) and the CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2017 ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second and then return.

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

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

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

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

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

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

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

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

All investments will be denominated in sterling.

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

4.2 Creditworthiness policy

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

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

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

Table 14: Recommended Maximum Durations for Investments	
Sector Colour Code	Maximum Suggested Duration for Investment
Yellow	6 years*
Dark Pink	6 years**
Light Pink	6 years**
Purple	3 years
Blue	2 years***
Orange	2 years
Red	8 months
Green	120 days
No colour	Not to be used

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

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

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

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

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

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

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

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

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

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

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

UK banks – ring fencing

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

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

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

4.3 Country and sector limits

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

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

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

4.4 Investment strategy

In-house funds. Investments will be made with reference to the core balance and cash flow requirements and the outlook for short -term interest rates (i.e. rates for investments up to 12 months). Greater returns are usually obtainable by investing for longer periods. While an element of cash balances are required in order to manage the ups and downs of cash flow, where cash sums can be identified that could be invested for longer periods, the value to be obtained from longer term investments will be carefully assessed.

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

Investment returns expectations. Bank Rate is forecast to stay flat at 0.75% until quarter 2 2019 and not to rise above 1.25% by quarter 4 of 2020. Bank Rate forecasts for financial year ends (March) are

- 2018/19 0.75%
- 2019/20 1.25%
- 2020/21 1.50%
- 2021/22 2.00%

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

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

- 2018/19 0.75%
- 2019/20 0.90%
- 2020/21 1.15%
- 2021/22 1.65%

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

Investment treasury indicator and limit - total principal funds invested for greater than 365 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

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

Table 15: Principal Sums Invested for > 365 Days			
	2017/18	2018/19	2019/20
Limit	£70m	£70m	£70m

The current strategy as outlined in the body of these reports is to cash-back the Council's balance sheet reserves. It is expected that the majority of this will be in the form of 12 month fixed term deposits and/or certificates of deposit; however the Council currently have two fixed term deposits with other Local Authorities, with an original maturity period of 2 years, which offer security of funds along with a higher yield as a result of longer duration. With this in mind, the limit for principal sums invested for > 365 days has therefore been set at £70m to give the Council flexibility to extend the duration of deposits that are cash-backing the Council's reserves.

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

4.5 Investment risk benchmarking

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

4.6 End of year investment report

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

5 Appendices

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

5.1 APPENDIX: Economic Background

GLOBAL OUTLOOK. **World growth** has been doing reasonably well, aided by strong growth in the US. However, US growth is likely to fall back in 2019 and, together with weakening economic activity in China, overall world growth is likely to weaken.

Inflation has been weak during 2018 but, at long last, unemployment falling to remarkably low levels in the US and UK has led to a marked acceleration of wage inflation which is likely to prompt central banks into a series of increases in central rates. The EU is probably about a year behind in a similar progression.

KEY RISKS - central bank monetary policy measures

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

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

The world economy also needs to adjust to a sharp change in **liquidity creation** over the last five years where the US has moved from boosting liquidity by QE purchases, to reducing its holdings of debt. In addition, the European Central Bank has cut back its QE purchases substantially and is likely to end them completely by the end of 2018.

UK. The flow of positive economic statistics since the end of the first quarter this year has shown that pessimism was overdone about the poor growth in quarter 1 when adverse weather caused a temporary downward blip. Quarter 1 at 0.1% growth in GDP was followed by a return to 0.4% in quarter 2; quarter 3 is expected to be robust at around +0.6% but quarter 4 is expected to weaken from that level.

At their November meeting, the MPC repeated their well-worn phrase that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary or contractionary), than before the crash; indeed they gave a figure for this of around 2.5% in ten years time but declined to give a medium term forecast. However, with so much uncertainty around Brexit, they warned that the next move could be up or down, even if there was a disorderly Brexit. While it would be expected that Bank Rate could be cut if there was a significant fall in GDP growth as a result of a

disorderly Brexit, so as to provide a stimulus to growth, they warned they could also raise Bank Rate in the same scenario if there was a boost to inflation from a devaluation of sterling, increases in import prices and more expensive goods produced in the UK replacing cheaper goods previously imported, and so on. In addition, the Chancellor has held back some spare capacity to provide a further fiscal stimulus if needed.

It is unlikely that the MPC would increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. Getting parliamentary approval for a Brexit agreement on both sides of the Channel will take well into spring next year. However, in view of the hawkish stance of the MPC at their November meeting, the next increase in Bank Rate is now forecast to be in May 2019. The following increases are then forecast to be in February and November 2020 before ending up at 2.0% in February 2022.

Inflation. The Consumer Price Index (CPI) measure of inflation has been falling from a peak of 3.1% in November 2017 to 2.4% in October. In the November Bank of England quarterly inflation report, inflation was forecast to still be marginally above its 2% inflation target two years ahead, (at about 2.1%), given a scenario of minimal increases in Bank Rate. This inflation forecast is likely to be amended upwards due to the Bank's inflation report being produced prior to the Chancellor's announcement of a significant fiscal stimulus in the Budget; this is likely to add 0.3% to GDP growth at a time when there is little spare capacity left in the economy, particularly of labour.

As for the **labour market** figures in September, unemployment at 4.1% was marginally above a 43 year low of 4% on the Independent Labour Organisation measure. A combination of job vacancies hitting an all-time high, together with negligible growth in total employment numbers, indicates that employers are now having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to 3.2%, (3 month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates less CPI inflation), earnings are currently growing by about 0.8%, the highest level since 2009. This increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This tends to confirm that the MPC was right to start on a cautious increase in Bank Rate in August as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy.

In the **political arena**, there is a risk that the current Conservative minority government may be unable to muster a majority in the Commons over Brexit. However, our central position is that Prime Minister May's government will endure, despite various setbacks, along the route to reaching an orderly Brexit in March 2019. If, however, the UK faces a general election in the next 12 months, this could result in a potential loosening of monetary and fiscal policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

USA. President Trump's massive easing of fiscal policy is fuelling a, (temporary), boost in consumption which has generated an upturn in the rate of strong growth which rose from 2.2%, (annualised rate), in quarter 1 to 4.2% in quarter 2 and 3.5%, (3.0% y/y), in quarter 3, but also an upturn in inflationary pressures. In particular, wage rates were increasing at 3.1% y/y in October and heading higher due to unemployment falling to a 49 year low of 3.7%. With CPI inflation over the target rate of 2% and on a rising trend towards 3%, the Fed increased rates another 0.25% in September to between 2.00% and 2.25%, this being the fourth increase in 2018. They also indicated that they expected to increase rates four more times by the end of 2019. The dilemma, however, is what to do when the temporary boost to consumption wanes, particularly as the recent imposition of tariffs on a number of countries' exports to the US, (China in particular), could see a switch to US production of some of those goods, but at higher prices. Such a scenario would invariably make any easing of monetary policy harder for the Fed in the second half of 2019. However, a combination of an expected four increases in rates of 0.25% by the end of 2019, together with a waning of the boost to economic growth from the fiscal stimulus in 2018, could combine to depress growth below its potential rate, i.e. monetary policy may prove to be

too aggressive and lead to the Fed having to start on cutting rates. The Fed has also been unwinding its previous quantitative easing purchases of debt by gradually increasing the amount of monthly maturing debt that it has not been reinvesting.

The tariff war between the US and China has been generating a lot of heat during 2018, but it is not expected that the current level of actual action would have much in the way of a significant effect on US or world growth. However, there is a risk of escalation. The results of the mid-term elections are not expected to have a material effect on the economy.

Eurozone. Growth was 0.4% in quarters 1 and 2 but fell back to 0.2% in quarter 3, though this is probably just a temporary dip. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of manufacturing exports e.g. cars. For that reason, although growth is still expected to be in the region of nearly 2% for 2018, the horizon is less clear than it seemed just a short while ago. Having halved its quantitative easing purchases of debt in October 2018 to €15bn per month, the European Central Bank has indicated it is likely to end all further purchases in December 2018. Inflationary pressures are starting to build gently so it is expected that the ECB will start to increase rates towards the end of 2019.

China. Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems. Progress has been made in reducing the rate of credit creation, particularly from the shadow banking sector, which is feeding through into lower economic growth. There are concerns that official economic statistics are inflating the published rate of growth.

Japan - has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy. It is likely that loose monetary policy will endure for some years yet to try to stimulate growth and modest inflation.

Emerging countries. Argentina and Turkey are currently experiencing major headwinds and are facing challenges in external financing requirements well in excess of their reserves of foreign exchange. However, these countries are small in terms of the overall world economy, (around 1% each), so the fallout from the expected recessions in these countries will be minimal.

INTEREST RATE FORECASTS

The interest rate forecasts provided by Link Asset Services in paragraph 3.2 are predicated on an assumption of an agreement being reached on Brexit between the UK and the EU. In the event of an orderly non-agreement exit, it is likely that the Bank of England would take action to cut Bank Rate from 0.75% in order to help economic growth deal with the adverse effects of this situation. This is also likely to cause short to medium term gilt yields to fall. If there was a disorderly Brexit, then any cut in Bank Rate would be likely to last for a longer period and also depress short and medium gilt yields correspondingly. It is also possible that the government could act to protect economic growth by implementing fiscal stimulus.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably neutral.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates, are probably also even and are broadly dependent on how strong GDP growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively.

One risk that is both an upside and downside risk, is that all central banks are now working in very different economic conditions than before the 2008 financial crash as there has been a major increase in consumer and other debt due to the exceptionally low levels of borrowing rates that have prevailed for ten years since 2008. This means that the neutral rate of interest in an economy, (i.e. the rate that is neither expansionary nor deflationary), is difficult to determine definitively in this new environment, although central banks have made statements that they expect it to be much lower than before 2008. Central banks could therefore either over or under do increases in central interest rates.

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

- **Brexit** – if it were to cause significant economic disruption and a major downturn in the rate of growth.
- **Bank of England monetary policy** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis**, possibly in Italy, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March of a government which has made a lot of anti-austerity noise. At the time of writing, the EU has rejected the proposed Italian budget and has demanded cuts in government spending which the Italian government has refused. The rating agencies have started on downgrading Italian debt to one notch above junk level. If Italian debt were to fall below investment grade, many investors would be unable to hold it. Unsurprisingly, investors are becoming increasingly concerned by the actions of the Italian government and consequently, Italian bond yields have risen sharply – at a time when the government faces having to refinance large amounts of debt maturing in 2019.
- Weak capitalisation of some **European banks**. Italian banks are particularly vulnerable; one factor is that they hold a high level of Italian government debt - debt which is falling in value. This is therefore undermining their capital ratios and raises the question of whether they will need to raise fresh capital to plug the gap.
- **German minority government**. In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. Then in October 2018, the results of the Bavarian and Hesse state elections radically undermined the SPD party and showed a sharp fall in support for the CDU. As a result, the SPD is reviewing whether it can continue to support a coalition that is so damaging to its electoral popularity. After the result of the Hesse state election, Angela Merkel announced that she would not stand for re-election as CDU party leader at her party's convention in December 2018. However, this makes little practical difference as she is still expected to aim to continue for now as the Chancellor. However, there are five more state elections coming up in 2019 and EU parliamentary elections in May/June; these could result in a further loss of electoral support for both the CDU and SPD which could also undermine her leadership.
- **Other minority eurozone governments**. Spain, Portugal, Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile. Sweden is also struggling to form a government due to the anti-immigration party holding the balance of power, and which no other party is willing to form a coalition with.
- **Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU while Italy, this year, has also elected a strongly anti-immigration government. Elections to the EU parliament are due in May/June 2019.

- Further increases in interest rates in the US could spark a **sudden flight of investment funds** from more risky assets e.g. shares, into bonds yielding a much improved yield. In October 2018, we have seen a sharp fall in equity markets but this has been limited, as yet. Emerging countries which have borrowed heavily in dollar denominated debt, could be particularly exposed to this risk of an investor flight to safe havens e.g. UK gilts.
- There are concerns around the level of **US corporate debt** which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions. This has resulted in the debt of many large corporations being downgraded to a BBB credit rating, close to junk status. Indeed, 48% of total investment grade corporate debt is now rated at BBB. If such corporations fail to generate profits and cash flow to reduce their debt levels as expected, this could tip their debt into junk ratings which will increase their cost of financing and further negatively impact profits and cash flow.
- **Geopolitical risks**, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

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

- **Brexit** – if both sides were to agree a compromise that removed all threats of economic and political disruption.
- **The Fed causing a sudden shock in financial markets** through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal of QE, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.
- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- **UK inflation**, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

Brexit timetable and process

Date	Process
March 2017	UK government notified the European Council of its intention to leave under the Treaty on European Union Article 50 on 29 March 2019
25.11.18	EU27 leaders endorsed the withdrawal agreement
21.12.18 – 8.1.19	UK Parliamentary recess
w/c 14.01.19	Vote in UK Parliament on the agreement
21.01.19 – 29.3.19	Second vote (?) in UK parliament if first vote rejects the deal
21.01.19	Vote in Parliament on a 'no deal' scenario; if approved
By 29.03.19	Then ratification by EU Parliament requires a simple majority
By 29.03.19	If UK and EU parliaments agree the deal, EU Council needs to approve the deal; 20 countries representing 65% of the EU population must agree
29.03.19	UK leaves the EU (or asks the EU for agreement to an extension of the Article 50 period if UK Parliament rejects the deal and no deal departure)
29.03.19	If an agreement is reached with the EU on the terms of Brexit, then this will be followed by a proposed transitional period ending around December 2020

UK continues as a full EU member until March 2019 with access to the single market and tariff free trade between the EU and UK. Different sectors of the UK economy may leave the single market and tariff free trade at different times during the transitional period.

The UK and EU would attempt to negotiate, among other agreements, a bi-lateral trade agreement over that period.

The UK would aim for a negotiated agreed withdrawal from the EU, although the UK could also exit without any such agreements in the event of a breakdown of negotiations.

If the UK exits without an agreed deal with the EU, World Trade Organisation rules and tariffs could apply to trade between the UK and EU - but this is not certain.

On full exit from the EU: the UK parliament would repeal the 1972 European Communities Act.

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

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

Treasury risks

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

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

Controls on treasury risks

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

Unlimited investments

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

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

Objectives of each type of investment instrument

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

1. DEPOSITS

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

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

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

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

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

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

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

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

4. SECURITIES ISSUED OR GUARANTEED BY GOVERNMENTS

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

- 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 will involve the Council subscribing £332,806 of subordinated debt to the SPV that has been set up to deliver the Newbattle Centre project (2 year construction and 25 year operational contract length). The length of the investment will be 25 years with the subscription made at operation commencement of the contract. The repayment profile will comprise 81% of the principal remaining invested until the final two years of the contract. The risk associated with this type of investment will be mitigated through an annual assessment as a minimum to review the holding of such debt, and whether the exposure to risk arising from the investment has changed over the period.
- d. **Property fund.** This is a collective investment fund specialising in property. Rather than owning a single property with all the risk exposure that means to one property in one location rising or falling in value, maintenance costs, tenants actually paying their rent / lease etc, a collective fund offers the advantage of diversified investment over a wide portfolio of different properties. This can be attractive for authorities who want exposure to the potential for the property sector to rise in value. However, timing is critical to entering or leaving this sector at the optimum times of the property cycle of rising and falling values. Typically, the minimum investment time horizon for considering such funds is at least 3-5 years.

Table 1: Permitted Investments

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

1.1 Deposits

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

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

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

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

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

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

1.4 Securities issued or guaranteed by governments

Investment Category	* Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period	Max Transaction Value
Treasury Bills	UK sovereign rating	Sale T+1	Yes	100%	50 years	£15m
UK Government Gilts	UK sovereign rating	Sale T+1	Yes	100%	50 years	£15m
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	£15m
Sovereign bond issues (other than the UK govt)	AAA (or state your criteria if different)	Sale T+1	Yes	100%	50 years	£15m
Bonds issued by multilateral development banks	AAA (or state your criteria if different)	Sale T+1	Yes	10%)	50 years	£15m

1.5 Securities issued by corporate organisations

Investment Category	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period	Max Transaction Value
Certificates of deposit issued by banks and building societies	Yellow Purple Blue Orange Red Green No Colour	Sale T+1	Yes	100%	Up to 6 yrs Up to 3 yrs Up to 2 yrs Up to 2 yrs Up to 7 mths Up to 100 days Not for use	£15m
Commercial paper other	Yellow Purple Blue Orange Red Green No Colour	Sale T+0	Yes	100%	Up to 6 yrs Up to 3 yrs Up to 2 yrs Up to 2 yrs Up to 7 mths Up to 100 days Not for use	£15m
Floating rate notes	Yellow Purple Blue Orange Red Green No Colour	Sale T+0	Yes	100%	Up to 6 yrs Up to 3 yrs Up to 2 yrs Up to 2 yrs Up to 7 mths Up to 100 days Not for use	£15m
Corporate Bonds other	Yellow Purple Blue Orange Red Green No Colour	Sale T+3	Yes	100%	Up to 6 yrs Up to 3 yrs Up to 2 yrs Up to 2 yrs Up to 7 mths Up to 100 days Not for use	£15m

1.6 Other

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

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

Midlothian Council Permitted Investments, Associated Controls and Limits

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

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

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

j. Corporate bonds (Medium to high risk depending on period & credit rating)	These are marketable securities issued by financial and corporate institutions. Counterparty risk will vary and there is risk to value of capital loss arising from selling ahead of maturity if combined with an adverse movement in interest rates. Liquidity risk will be low.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's. The selection defaults to the lowest available colour band / credit rating to provide additional risk control measures. Corporate bonds will be restricted to those meeting the base criteria. Day to day investment dealing with this criteria will be further strengthened by the use of additional market intelligence.	As shown in Appendix 5.2.
Other types of investments			
k. Loans to third parties	Using the example of a loan to a RSL, these would be medium risk investments, exhibiting higher risks than categories (a)-(f) above. They are also highly illiquid and are only repaid at the end of a defined period of time (up to 20 years) or on the sale of a property, whichever is the earlier.	The risk associated with such an investment would be mitigated through the application of a premium on the loan rate. The Council will also request that a standard security is taken over the property which would allow the Council to require the sale of the homes to another landlord, providing greater risk mitigation.	£25m
l. Non-local authority shareholdings	These are non-service investments which may exhibit market risk, be only considered for longer term investments and will be likely to be liquid.	Any non-service equity investment will require separate Member approval and each application will be supported by the service rational behind the investment and the likelihood of loss.	Per Existing

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

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

5.4 APPENDIX: Approved countries for investments

Based on the lowest available rating

AAA

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

AA+

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

AA

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

AA-

- Belgium
- Qatar

5.5 APPENDIX: Treasury management scheme of delegation

(i) Full Council

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

(iii) Audit Committee

- reviewing 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.