Item: 7

Policy and Resources Committee: 19 February 2019.

Treasury Management Strategy Statement and Annual Investment Strategy.

Report by Head of Finance.

1. Purpose of Report

To consider the treasury management strategy statement and annual investment strategy for financial year 2019 to 2020.

2. Recommendations

It is recommended:

That the Treasury Management Strategy Statement and Annual Investment Strategy, attached as Appendix 1 to this report, be approved for financial year 2019 to 2020.

3. Background

3.1.

Section 21 of the Financial Regulations confirms that the Council has adopted the key recommendations of CIPFA's Treasury Management in the Public Sector Code of Practice (the Code).

3.2.

The Local Government in Scotland Act 2003 and supporting regulations require the Council to "have regard to" the following:

3.2.1

The 'Prudential Code for Capital Finance in Local Authorities', published by the Chartered Institute of Public Finance and Accountancy (CIPFA) in 2009, and updated in 2017, which requires the Council to set Prudential and Treasury Indicators for the next three years as a minimum to ensure that the Council's capital investment plans are affordable, prudent and sustainable. The Prudential Code 2017 introduced a new requirement for authorities to produce an annual capital strategy.

3.2.2.

The 'Treasury Management in the Public Services: Code of Practice and Cross-sectoral Guidance Notes', published by CIPFA in 2009, which requires the Council to set out its treasury management strategy for borrowing and investment and how it will give priority to security and liquidity in managing its investments.

3.3.

A principle focus of the codes of practice referred to above is an expanded definition of treasury management to include investment activities, together with a requirement to assess the creditworthiness of counterparties with a view to minimising the risk to councils when considering investment decisions.

3.4.

The Local Government Investment (Scotland) Regulations 2010 permits local authorities to make investments subject to them gaining the consent of Scottish Ministers. Finance circular 5/2010 sets out the terms of that consent and requires local authorities to again “have regard to” the codes of practice referred to above when managing their investments.

3.5.

This regulation not only provides greater autonomy to local authorities to manage their own investment activities, but also requires local authorities to consider the totality of their investment activity. As such, this regulation covers a much wider remit than the traditional view of treasury management.

3.6.

The consent applies to a range of investments and covers, for example, the investment of temporary surplus funds with banks and similar institutions, shareholdings in companies or joint ventures and loans to group undertakings and third parties. It also covers the Council’s Strategic Reserve Fund, including investment properties.

4. Treasury Strategy Requirements

4.1.

The Council’s investment priorities can be summarised as maintaining:

- The security of capital.
- The liquidity of its investments.

4.2.

The Council aims to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of the Council is relatively low in order to give priority to security of its investments. This is in keeping with the nature of the Strategic Reserve Fund, which is to provide for the benefit of Orkney and its inhabitants, whilst having regard to the Fund’s long term commitments in terms of the terminal decline and decommissioning of the Flotta Oil Terminal in the future.

4.3.

By contrast, however it is notable that an increasing focus within the investment strategy for the Strategic Reserve Fund is given towards being able to generate sufficient income from investments activities so as to be able to meet both the short term funding commitments on the Fund, while at the same time maintaining the value of the Fund in real terms. It is considered that while this approach aims to ensure the affordability of the Fund going forward, an additional investment risk is actively being taken by the Council, partly to take advantage of opportunities as they arise in the financial markets, but also to compensate for the volatility of investment returns.

4.4.

A key area of the investment regulations, referred to at section 3.4 above, is the requirement for local authorities to set out in their Strategy the types of investment that they will permit in the financial year, otherwise known as permitted investments. The Council is required to set a limit to the amounts that may be held in such investments at any time in the year. Some types of investment may be classed as unlimited, but the reasons for doing so must be set out in the Strategy and be consistent with risk assessments undertaken. A list of permitted investments is detailed in Appendix 5.5 to the Treasury Management Strategy Statement and Annual Investment Strategy, attached as Appendix 1 to this report.

4.5.

From the Prudential Code, it is clear that a local authority must not borrow more than, or in advance of, need purely to profit from the investments of the extra sums borrowed. In terms of conditions under which borrowing may be taken early a requirement exists to demonstrate that, over the medium term, borrowing will only be for a capital purpose. In other words, the Council is required to demonstrate that borrowing does not, except in the short term, exceed the total capital financing requirement for the current and next two financial years. This effectively sets a limit on the total amount of borrowing that is acceptable under the Code to provide flexibility in treasury management, but also ensure that any borrowing is for capital purposes only. The Council's policy on borrowing in advance of need is set out in paragraph 3.5 of the Treasury Management Strategy Statement and Annual Investment Strategy.

4.6.

In terms of reporting requirements, it should be noted that the Annual Investment Strategy and Annual Investment Report are central to the consent from Scottish Ministers, as is the requirement to produce an annual treasury management strategy and annual report within the CIPFA Treasury Code. The Authority's net treasury position is determined by the relationship between its capital financing requirement (the need to borrow) and its balances and reserves (the potential to invest). As such, an integrated strategy covering capital investment, borrowing and the investment of surplus funds is recommended by Scottish Ministers. A mid-year report followed by an outturn report at the end of the financial year covering the same elements is also required.

4.7.

While the investment regulations do allow for the treasury management and investment strategies to be determined at a local level, it is clear that with this greater freedom comes greater responsibility, and the onus remains very much on local authorities to act prudently with regard to their investment and treasury activities at all times.

4.8.

The main points to note from the Treasury Management Strategy and Annual Investment Strategy for 2019 to 2020, attached as Appendix 1 to this report, are summarised as follows:

4.8.1.

The key issue now is that the period of stimulating economic recovery and warding off the threat of deflation is coming towards its close and a new period has already started in the United States, and more recently in the United Kingdom, on reversing those measures, namely by raising central rates and reducing central banks' holdings of government and other debt.

4.8.2.

On 2 August 2018, the Monetary Policy Committee increased the Bank Rate by 0.25% to 0.75%. This is the first increase in Bank Rate above 0.50% since the financial crash. The Monetary Policy Committee has also given forward guidance that they expect the next increase to Bank rate in May 2019 on the assumption that Parliament and EU agree a Brexit deal in the first quarter of 2019.

4.8.3.

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

4.8.4.

The counterparty limit for the Council's treasury management, or cash balances, is 25% or £10,000,000 for any one institution or group at any one time. This reflects in particular the steady reduction in the size of these balances and the need to maintain adequate diversification within the portfolio of temporary loan deposits that are managed in-house. This limit does not apply to the Council's portfolio of investments held under the Strategic Reserve Fund that are managed by external fund managers under separate Investment Management agreements.

4.8.5.

The Bank of England's Quarterly Inflation Report for November 2018 reported inflation at 2.3% with forecast inflation to still be marginally above its 2% inflation target two years ahead.

4.8.6.

The Annual Investment Strategy has been updated to reflect the proposed outcome of the annual review of the Strategic Reserve Fund which was considered by the Policy and Resources Committee on 12 February 2019, as part of the budget setting process, and due to be considered by Council on 21 February 2019.

4.8.7.

The Council's existing capital programme includes approved capital project expenditure of £64,103,000 over the 3 year period 2019 to 2022, with an identified capital financing borrowing requirement of £24,978,000.

4.8.8.

The Council's net capital financing requirement is forecast to increase from £52,392,000 to £77,370,000 over the 3 year period from 2019 to 2022, being a net increase of £24,978,000 after allowing for the repayment of principal.

4.8.9.

In terms of core funds and expected investment balances, the Council's resources and anticipated cash flow balances are forecast to increase from £230,412,000 to £232,641,000 or by only £2,229,000 over the 3 year period 2018 to 2021.

4.9.

The affordability of the capital programme relative to the Council's overall finances over the 3 year period 2019 to 2022 can be measured as the ratio of cost of capital, or loan charges, relative to net revenue stream:

- General Fund Services – 1.5% increasing to 2.4%.
- Scapa Flow Oil Port – 2.5% increasing to 23.2%.
- Miscellaneous Piers – 16.3% decreasing to 14.8%.
- Housing Revenue Account – 29.3% increasing to 29.5%.

4.10.

While the ratio for General Fund Services is still considered to be relatively low, with an increase of only 0.9% over the period, this can be attributed directly to the Council's past policy of accelerating debt repayments. By contrast, the Housing Revenue Account is forecast to increase by only 0.2% to 29.5%. However, this total is equivalent to slightly less than one-third of all rent income being committed to servicing the long term debt associated with the Council's house building strategy. This is considered to represent a significant commitment on the Housing Revenue Account and as such 35% should be regarded as the upper limit for the cost of capital relative to net revenue on the Housing Revenue Account for the term of the current 5 year capital programme.

4.11.

The significant increase on the cost of capital being incurred by Scapa Flow Oil Port of 20.7% to 23.2%, is equivalent to a quarter of the income generated on the oil port being committed to servicing the long-term debt associated with the costs of capital investment in a new pilot boat and 2 new tugs.

4.12.

The General Capital Grant for financial year 2019 to 2020 has been confirmed as £7,447,000, which is £1,058,000 higher than the settlement for financial year 2018 to 2019. The General Capital Grant for 2016 to 2017 included a reduction of £1,198,000 which the Scottish Government has indicated will only be added to the local government capital share in the next Spending Review over the period 2018 to 2020. This uncertainty therefore has the potential to impact on the Council's capital financing requirement going forward.

4.13.

The Council's authorised limit for external debt is scheduled to increase by £5,000,000 to £80,000,000 by the end of the 3 year period 2019 to 2022, with the operational boundary for external debt also increasing by £5,000,000 to £65,000,000 across the same period. As a key prudential indicator, the authorised limit represents a control on the maximum level of borrowing and as a limit beyond which external debt is prohibited. This limit is set or revised by the Council. As such, this represents a level of external debt that could be afforded in the short term, but is not sustainable over the longer term.

4.14.

By contrast, the operational boundary represents a limit beyond which external debt is not normally expected to exceed and, in effect, represents the extent of the authority delegated to the Head of Finance. Accordingly, with existing Public Works Loan Board borrowings of £30,000,000 as at 31 March 2019, and £5,000,000 due to be repaid in May 2019, the Head of Finance would be authorised to respond to favourable movements in the financial markets and effect additional borrowing of up to £40,000,000.

5. Corporate Governance

This report relates to the Council complying with its governance and financial processes and procedures and therefore does not relate specifically to progressing the Council's priorities.

6. Equalities Impact

An Equality Impact Assessment has been carried out and is attached as Appendix 2 to this report.

7. Financial Implications

A requirement exists for the Council to adopt a Treasury Management Policy and thereafter approve a Treasury Management Strategy and Annual Investment Strategy each year.

8. Legal Aspects

8.1.

It is the duty of a local authority to make arrangements which secure best value. Treasury Management arrangements help the Council comply with this obligation.

8.2.

Section 40 of the Local Government in Scotland Act 2003 provides local authorities with the power to invest money in accordance with regulations made by Scottish Ministers.

8.3.

Section 95 of the Local Government Act 1973 states that every local authority shall make arrangements for the proper administration of their financial affairs and shall secure that the proper officer has responsibility for the administration of those affairs.

9. Contact Officers

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10. Appendices

Appendix 1: Treasury Management Strategy Statement and Annual Investment Strategy for 2019 to 2020.

Appendix 2: Equality Impact Assessment.

Treasury Management Strategy Statement

and Annual Investment Strategy

Orkney Islands Council

2019/20

Contents

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. The capital strategy is being reported separately.

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

a. Prudential and treasury indicators and treasury strategy (this report) - The first, and most important report covers is forward looking and covers:

- the capital plans (including prudential indicators).
- 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) including treasury indicators, and
- a permitted investment strategy (the parameters on how investments are to be managed).

b. A mid-year treasury management report – This is primarily a progress report and will update members with the progress of the capital position, amending prudential indicators as necessary, and whether any policies require revision. In addition, this council will receive quarterly update reports.

c. An annual treasury report – This is a backward looking review document and provides details of a selection of actual prudential and treasury indicators 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 Policy and Resources Committee.

1.3. Treasury Management Strategy for 2019/20

The strategy for 2019/20 covers two main areas:

- Capital Issues:
  - Capital expenditure plans and the associated prudential indicators.
  - The loans fund repayment policy.
- Treasury Management Issues:
  - Current treasury position.
  - Treasury indicators which limit the treasury risk and activities of the Council.
  - Prospects for interest rates.
  - Borrowing strategy.
  - Policy on borrowing in advance of need.
  - Debt rescheduling.
  - Investment strategy.
  - Creditworthiness policy.
  - Policy on use of external service providers.

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

1.4. Training

The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsible for scrutiny. The members have undertaken training during 2018/19 in respect of developing a long-term capital investment strategy, Ethical Investments, Investment Strategy and Treasury Management. Further training will be arranged as required.

The training needs of treasury management officers are periodically reviewed.

1.5. Treasury Management Consultants.

The Council uses 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 the services of 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. Capital Prudential Indicators 2018/19 – 2020/21

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. Members are asked to approve the capital expenditure forecasts effective as at 1 April 2019:

Capital expenditure £m	2017/18 Actual	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
Non-HRA	**14.635**	**13.930**	**30.788**	**22.486**	**6.830**
HRA	**0.613**	**0.250**	**2.500**	**1.415**	**0.084**
Total	**14.760**	**14.180**	**33.288**	**23.901**	**6.914**

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

The table below summarises the above capital expenditure plans and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a funding borrowing need.

Financing of capital expenditure £m	2017/18 Actual	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
Capital receipts	0.734	0.150	0.150	0.150	0.150
Capital grants	8.070	8.415	13.024	7.517	6.600
Capital reserves	0.00	0.343	4.060	5.644	0.000
Revenue	3.072	0.584	0.692	0.569	0.569
Net financing need for the year	**2.884**	**4.688**	**15.362**	**10.021**	**(0.405)**

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 through a revenue or capital resource, will increase the CFR.

The CFR does not increase indefinitely, as prudent annual repayments from revenue need to be made which reflect the useful life of capital assets financed by 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 include a borrowing facility by the PFI, PPP lease provider and so the Council is not required to separately borrow for these schemes. The Council currently has no such schemes within the CFR.

The Council is asked to approve the CFR projections below:

£m	2017/18 Actual	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
Capital Financing Requirement					
CFR – non housing	33.268	37.706	52.982	61.588	61.099
CFR – housing	14.436	14.686	14.772	16.187	16.271
Total CFR	**47.704**	**52.392**	**67.754**	**77.775**	**77.370**
Movement in CFR	**(1.372)**	**3.091**	**13.609**	**7.608**	**(3.200)**

Movement in CFR represented by					
Net financing need for the year (above)	2.884	4.688	15.362	10.021	(0.405)
Less loan fund repayments and other financing movements	(4.256)	(1.597)	(1.753)	(2.413)	(2.795)
Movement in CFR	**(1.372)**	**3.091**	**13.609**	**7.608**	**(3.200)**

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

2.3. Core funds and expected investment balances

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

Year End Resources £m	2017/18 Actual	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
Fund balances / reserves	249.283	247.778	245.402	245.363	250.007
Capital receipts	2.630	2.630	1.690	1.690	1.690
Provisions	2.802	2.802	2.802	2.802	2.802
Other	8.585	8.600	8.600	8.600	8.600
Total core funds	**263.300**	**261.810**	**267.494**	**258.455**	**263.099**
Working capital*	(2.798)	(2.800)	(2.800)	(2.800)	(2.800)
Under/over borrowing**	(17,504)	(22.221)	(22.611)	(22.661)	(22.284)
Expected investments	**242.998**	**236.789**	**242.083**	**232.994**	**238.015**

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

2.4. Statutory repayment of loans fund advances

The Council is required to set out its policy for the statutory repayment of loans fund advances prior to the start of the 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 2019/20:

For all loans fund advances, the policy will be to maintain the practice of previous years and apply the Asset Method, with all loans fund advances being repaid in equal instalments of principal with reference to the life of the asset.

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 and the Council's capital strategy. 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 31 December 2018 are shown below for both borrowing and investments.

TREASURY PORTFOLIO				
	actual	actual	current	current
	31.3.18	**31.3.18**	**31.12.18**	**31.12.18**
Treasury investments	£000	%	£000	%
banks	12,200	5%	13,564	6%
building societies - unrated	0	0%	0	0%
building societies - rated	0	0%	0	0%
local authorities	11,000	4%	12,000	5%
DMADF (H.M.Treasury)	0	0%	0	0%
money market funds	3,500	1%	5,300	2%
certificates of deposit	2,000	1%	6,000	2%
Total managed in house	**28,700**	**12%**	**36,864**	**15%**
property investments	21,557	9%	21,676	9%
local investments	8,722	4%	10,222	4%
Strategic Reserve Fund managed in house	**30,279**	**12%**	**31,898**	**13%**
bond funds	47,900	19%	47,700	19%
diversified growth fund	37,400	15%	36,800	15%
equity fund	88,500	36%	87,300	36%
credit strategies fund	20,200	8%	19,800	8%
property funds	21,400	9%	22,300	9%
Strategic Reserve Fund managed externally	**215,400**	**88%**	**213,900**	**87%**
Total treasury investments	**245,679**	**100%**	**245,798**	**100%**
Treasury external borrowing				
local authorities	0	0%	0	0%
PWLB	30,000	99%	30,000	99%
other	200	1%	171	1%
LOBOs	0	0%	0	0%
Total external borrowing	**30,200**	**100%**	**30,171**	**100%**
Net treasury investments / (borrowing)	**215,479**		**215,627**	

The Council's forward projections for borrowing 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.

£m	2017/18 Actual	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
External Debt					
Debt at 1 April					
Expected change in Debt	35.228	30.200	30.171	45.143	55.114
Other long-term liabilities (OLTL)	(5.028)	(0.029)	(0.028)	(0.029)	(0.028)
Expected change in OLTL	0.000	0.000	15.000	10.000	0.000
Actual gross debt at 31 March	**30.200**	**30.171**	**45.143**	**55.114**	**55.086**
The Capital Financing Requirement	**47.704**	**52.392**	**67.754**	**77.775**	**77.370**
Under / (over) borrowing	**17.504**	**22.221**	**22.611**	**22.661**	**22.284**

Within the prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well-defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2018/19 and the following two financial years. This allows some flexibility for limited early borrowing for future years but ensures that borrowing is not undertaken for revenue purposes.

The Head of Finance 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 and the ability to fund under-borrowing by other cash resources.

Operational boundary £m	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
Debt	60.000	60.000	60.000	65.000
Other long term liabilities	0.000	0.000	0.000	0.000
Total	60.000	60.000	60.000	65.000

The authorised limit for external debt. This is a key prudential indicator and represents a control on the maximum level of borrowing. This represents a legal 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 Council is asked to approve the following authorised limit:

Authorised limit £m	**2018/19 Estimate**	**2019/20 Estimate**	**2020/21 Estimate**	**2021/22 Estimate**
Debt	75.000	75.000	75.000	80.000
Other long term liabilities	0.000	0.000	0.000	0.000
Total	75.000	75.000	75.000	80.000

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 our central view.

Link Asset Services Interest Rate View	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.75%	1.75%	1.75%	2.00%
3 Month LIBID	0.90%	1.00%	1.10%	1.20%	1.30%	1.40%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%
6 Month LIBID	1.00%	1.20%	1.30%	1.40%	1.50%	1.60%	1.70%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%
12 Month LIBID	1.20%	1.30%	1.40%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%	2.30%	2.40%
5yr PWLB Rate	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%	2.80%	2.80%
10yr PWLB Rate	2.50%	2.60%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%
25yr PWLB Rate	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB Rate	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%	3.40%

The flow of generally positive economic statistics after the quarter ended 30 June 2018 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 became increasingly strong during 2018 until slowing significantly during the last quarter. At their November quarterly Inflation Report 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. On a major assumption that Parliament and the EU agree a Brexit deal in the first quarter of 2019, then the next increase in Bank Rate is 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 2.25 – 2.50% in December 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 therefore saw US 10 year bond Treasury yields rise above 3.2% during October 2018 and also investors causing a sharp fall in equity prices as they sold out of holding riskier assets. However, by early January 2019, US 10 year bond yields had fallen back considerably on fears that the Fed was being too aggressive in raising interest rates and was going to cause a recession. Equity prices have been very volatile on alternating good and bad news during this period.

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 while they were on a rising trend during the first half of the year, they have backtracked since then until early January. 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.

3.4. Borrowing strategy

The Council is currently maintaining an under-borrowed position. 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 2019/20treasury operations. The Head of Finance 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 Council traditionally relied on its ability to finance its capital spending programmes through the use of internal borrowings. However, in approving the development of a major Schools Investment Programme in 2008 at an estimated capital cost of £58 million, and thereafter a significant Social Housing build programme, it was acknowledged that this approach would need to change. In particular, as interest rates were originally predicted to start to increase in 2010, the Council increased external borrowings to £40M to fund at least part of this sizable programme of capital works. At that time, this was regarded as an effective way for the Council to manage the risk of interest rate movements over the life of the programme, which could otherwise have the potential to adversely impact on the affordability of this programme going forward including future Council budgets. This also applied in the case of the house build programme where any increase in interest rates would impact on the affordability of the overall development, which relies on the ability of housing tenants to support the loan charges in the form of tenant rent increases.

Whilst the subsequent decision of Scottish Government to change the funding structure for the Schools Investment Programme mid 2010 effectively reduced the Council's borrowing requirements for future years, the terms of the borrowings were still regarded as favourable at that time such that the Council was well placed to benefit from savings on loan charges in the longer term.

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 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.

Borrowing in advance will be made within the constraints that:

- It will be limited to no more than 50% of the expected increase in borrowing need (CFR) over the three year planning period, and
- The Authority would not look to borrow more than 24 months in advance of need.

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:

- Generation of cash savings and / or discounted cash flow savings.
- Helping to fulfil the treasury strategy.
- Enhancing 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.

3.7. Municipal Bond Agency

It is possible that the Municipal Bond Agency will be offering loans to local authorities in the future. The Agency hopes that the borrowing rates will be lower than those offered by the Public Works Loan Board (PWLB). This Authority may make use of this new source of borrowing as and when appropriate.

4. Annual Investment Strategy

4.1. Investment Policy

The Council’s investment policy implements the requirements of the 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 above regulations and guidance place a high priority on the management of risk. The Council’s investment priorities will be security first, liquidity second and then return. This authority has adopted a prudent approach to managing risk and defines its risk appetite by the following means:

- Minimum acceptable **credit criteria** are applied in order to generate a list of highly creditworthy counterparties. This also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the short term and long-term ratings.
- **Other information:** 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 achieve this consideration 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 5.4. Appendix 5.5 expands on the risks involved in each type of investment and the mitigating controls.
- **Lending limits**, (amounts and maturity), for each counterparty will be set through applying the matrix table in paragraph 4.2.
- **Transaction limits** are set for each type of investment in appendix 5.4.
- This authority will set a limit for the amount of its investments which are invested for **longer than 365 days**, (see paragraph 4.4).
- Investments will only be placed with counterparties from countries with a specified minimum **sovereign rating**, (see paragraph 4.3).
- 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**.
- As a result of the change in accounting standards for 2018/19 under **IFRS 9,** this authority will consider the implications of investment instruments which could result in an adverse movement in the value of the amount invested and resultant charges at the end of the year to the General Fund. (This area is currently under review by LASAAC and the Scottish Government. Members will be updated when there is further news.) With much of the Council's investment instruments held in the Strategic Reserve Fund, as part of the Harbour Fund, it is not anticipated that the impact of IFRS 9 on the General Fund will be significant.
- Externally managed fund investments are managed by externally appointed fund managers operating within individual mandates as part of an agreed investment strategy which sets both the permitted asset class limit and range. The appointed fund managers are authorised to manage risk within these mandates.

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.

Changes in risk management policy from last year.

A review of the current investment strategy is ongoing with a view to achieving further diversification away from equity investments, into more illiquid longer term alternative asset classes including infrastructure, illiquid debt and secured income/finance.

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:

- Yellow – 5 years*.
- Dark Pink – 5 years for Ultra short dated bond funds with a credit score of 1.25.
- Light Pink – 5 years for Ultra short dated bond funds with a credit score of 1.5.
- Purple – 2 years.
- Blue – 1 year (only applies to nationalised or semi nationalised UK Banks).
- Orange – 1 year.
- Red – 6 months.
- Green – 100 days.
- No Colour – Not to be used.

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 a Short Term rating (Fitch or equivalents) of F1 and a Long Term rating of 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 on a weekly basis. The Council is alerted to changes to ratings of all three agencies through its use of our 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 it 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.

Y	Pi1	Pi2	P	B	O	R	G	N/C
1	1.25	1.5	2	3	4	5	6	7
Up to 5yrs	Up to 5yrs	Up to 5yrs	Up to 2yrs	Up to 1yr	Up to 1yr	Up to 6mths	Up to 100days	No Colour

Note: the yellow colour category is for UK Government debt, or its equivalent, money market funds and collateralised deposits where the collateral is UK Government Debt – see appendix 5.3.

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 countries with a minimum sovereign credit rating of AA- from Fitch (or equivalent). The list of countries that qualify using this credit criteria as at the date of this report are shown in Appendix 5.6. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

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 most 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 0.50% until quarter 4 2018 and not to rise above 1.25% by quarter 1 2021. Bank Rate forecasts for financial year ends (March) are:

Financial Year.	Bank Rate.
2018/19	0.50%
2019/20	0.75%
2020/21	1.00%
2021/22	1.25%

The suggested budgeted investment earnings rates for returns on investments placed for periods up to about three months during each financial year are as follows:

Financial Year.	Now.
2018/19	0.40%
2019/20	0.60%
2020/21	0.90%
2021/22	1.25%
2021/22	1.50%
2022/23	1.75%
2023/24	2.00%
Later years	2.75%

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:

Upper limit for principal sums invested for longer than 365 days			
	2019/20	2020/21	2021/22
Principal sums invested for longer than 365 days	£m 70	£m 70	£m 70

The budgeted investment earnings rates for returns on the Council's strategic reserve fund investments is derived from the approved investment strategy for the portfolio of investments that are managed by appointed external fund managers. A revised investment strategy was implemented in 2017, introducing a new allocation to Enhanced Yield Debt as an alternative to Government Bonds which should marginally improve investment returns going forward. This has been reflected in the forecast for the next three years as follows:

- 2018/2019 5.60%.
- 2019/2020 5.60%.
- 2020/2021 5.60%.

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 365 days) in order to benefit from the compounding of interest.

4.5. Investment risk benchmarking

The Council uses investment benchmarks to assess the investment performance of its investment portfolio both for in-house and external investments:

Investment Portfolio	Benchmark	Target Mandate
In-house cash balances	90-day LIBOR	Outperform benchmark
Bonds	UK Corporate Bonds (75%) - ML Sterling Non-Gilts All Stocks UNPO Index	Benchmark over a rolling 3 year period +0.75% p.a.
Equities	UK Equities (45%) - FTSE All Share Index Global Equities (55%) - MSCI All Country World Index (NDR)	Benchmark over a rolling 3 year period +1.5% p.a.
UK Property Fund	IPD All Balanced Property Fund Index Weighted Average	Outperform benchmark over a rolling 3 year period
Diversified Growth Fund	90-day LIBOR	Benchmark over a rolling 3 year period +3.0% p.a.
Enhanced Yield Debt Strategies or Multi-Asset Credit Fund	90-day LIBOR	Benchmark over a rolling 3 year period +5.0% p.a.

4.6. End of Year Investment Report

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

4.7. External Fund Managers

As at 31 March 2019, it is estimated that £217m of the Council's funds will be externally managed on a discretionary basis by externally appointed fund managers.

A review of the investment strategy for the Council's strategic reserve fund was undertaken by the Investments Sub-committee in 2016. While the review concluded that the existing strategy had been effective in adding value, and at the same time preserving the value of the Fund in real terms, it did identify scope for further added value through the introduction of a new allocation to enhanced yield debt focused strategies. During 2017/18 a transition programme developed in consultation with investment advisors was concluded, with the transfer of £20m, to the appointed specialist debt investment fund manager.

A further strategy review is currently taking place with a number of strategies being identified depending on whether the objective or focus of the Strategic Reserve Fund managed fund investments is to achieve growth or income generation going forward.

The Head of Finance, in consultation with Hymans Robertson, will develop the findings of the review into a set of specific proposals for a revised investment strategy of the Strategic Reserve Fund managed funds to be presented to a future meeting of the Investment Sub-Committee.

The Council's external fund manager(s) will comply with the Annual Investment Strategy. The investment management agreement(s) between the Council and the fund manager(s) additionally stipulate guidelines and duration and other limits in order to contain and control risk.

The minimum credit criteria to be used by the cash and managed fund manager(s) are set out in Table 2 of Appendix 5.3 on Permitted Investments.

Appendices

5.1. Prudential and treasury indicators.

5.2. Interest rate forecasts.

5.3. Economic background.

5.4. Treasury management practice TMP1 –permitted investments.

5.5. Treasury management practice TMP1 – credit and counterparty risk management.

5.6. Approved countries for investments.

5.7. Treasury management scheme of delegation.

5.8. The treasury management role of the section 95 officer.

5.1. The Capital Prudential and Treasury Indicators 2018/2019 – 2020/2021

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.

5.1.1. Capital expenditure.

Capital expenditure £m	2017/18 Actual	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
Social Care	1.344	3.715	8.268	8.806	1.371
Roads and Transportation	3.715	2.427	1.916	0.977	0.950
Education and Leisure	2.911	0.122	2.909	2.843	0.328
Marine Services	1.586	3.179	11.030	4.965	0.450
Other Services	5.079	4.487	6.665	4.895	3.731
Non-HRA	**14.635**	**13.930**	**30.788**	**22.486**	**6.830**
HRA	**0.125**	**0.250**	**2.500**	**1.415**	**0.084**
Total	**14.760**	**14.180**	**33.288**	**23.901**	**6.914**

5.1.2. Affordability prudential indicators.

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

5.1.2.1. 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.

%	2017/18 Actual	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
General Fund	3.1%	1.5%	1.7%	2.3%	2.4%
Scapa Flow Oil Port	2.4%	2.5%	6.5%	18.8%	23.2%
Miscellaneous Piers	16.7%	16.3%	16.3%	15.1%	14.8%
HRA	30.5%	29.3%	28.4%	29.0%	29.5%

The estimates of financing costs include current commitments as set out in the Council's approved capital programme.

5.1.2.2. HRA Ratios.

£	2017/18 Actual	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
HRA debt £m	**13.884**	**13.626**	**13.198**	**14.097**	**13.630**
HRA revenues £m	**3.604**	**3.721**	**3.810**	**4.019**	**4.099**
Ratio of debt to revenues %	**26.0**	**27.3**	**28.9**	**28.5**	**30.1**

£	2017/18 Actual	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
HRA debt £m	**13.884**	**13.626**	**13.198**	**14.097**	**13.630**
Number of HRA dwellings £m	**949**	**949**	**981**	**981**	**981**
Debt per dwelling £	**14,630**	**14,358**	**13,454**	**14,370**	**13,894**

5.1.3. Maturity Structure of Borrowing.

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:

Maturity structure of fixed interest rate borrowing 2019/20		
	Lower	**Upper**
Under 12 months	0%	0%
12 months to 2 years	10%	20%
2 years to 5 years	10%	20%
5 years to 10 years	0%	15%
10 years and above	55%	80%

5.1.4. Control of Interest Rate Exposure.

Please see paragraphs 3.3, 3.4 and 4.4.

5.2. Interest Rate Forecasts 2019 – 2022

PWLB rates and forecast shown below have taken into account the 20 basis point certainty rate reduction effective as of 1 November 2012.

Link Asset Services Interest Rate View													
	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.75%	1.75%	1.75%	2.00%
3 Month LIBID	0.90%	1.00%	1.10%	1.20%	1.30%	1.40%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%
6 Month LIBID	1.00%	1.20%	1.30%	1.40%	1.50%	1.60%	1.70%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%
12 Month LIBID	1.20%	1.30%	1.40%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%	2.30%	2.40%
5yr PWLB Rate	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%	2.80%	2.80%
10yr PWLB Rate	2.50%	2.60%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%
25yr PWLB Rate	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB Rate	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%	3.40%
Bank Rate													
Link Asset Services	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.75%	1.75%	1.75%	2.00%
Capital Economics	0.75%	1.00%	1.25%	1.50%	1.70%	1.75%	2.00%	2.00%	-	-	-	-	-
5yr PWLB Rate													
Link Asset Services	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%	2.80%	2.80%
Capital Economics	2.03%	2.15%	2.40%	2.65%	2.70%	2.75%	2.80%	2.85%	-	-	-	-	-
10yr PWLB Rate													
Link Asset Services	2.50%	2.60%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%
Capital Economics	2.43%	2.55%	2.80%	3.05%	3.05%	3.05%	3.05%	3.05%	-	-	-	-	-
25yr PWLB Rate													
Link Asset Services	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%	3.50%	3.50%	3.60%	3.60%
Capital Economics	2.96%	3.08%	3.33%	3.58%	3.53%	3.48%	3.43%	3.38%	-	-	-	-	-
50yr PWLB Rate													
Link Asset Services	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%	3.40%
Capital Economics	2.78%	2.90%	3.15%	3.40%	3.40%	3.40%	3.40%	3.40%	-	-	-	-	-

5.3. 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 and the eurozone, 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 an acceleration of wage inflation. The US Fed has therefore increased rates nine times and the Bank of England twice. However, the ECB is unlikely to start raising rates until late in 2019 at the earliest.

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 period of stimulating economic recovery and warding off the threat of deflation, is coming towards its close. A new period is well advanced in the US, and started 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 meant that both asset categories were exposed to the risk of a sharp downward correction and we did, indeed, see a sharp fall in equity values in the last quarter of 2018. 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.** At the time of writing, (early January 2019), financial markets are very concerned that the Fed is being too aggressive with its policy for raising interest rates and is likely to cause a recession in the US economy.

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 (currently about $50bn per month). In addition, the European Central Bank ended its QE purchases in December 2018.

UK. The flow of positive economic statistics since the end of the first quarter of 2018 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 and by a strong performance in quarter 3 of +0.6%. However, growth in quarter 4 is expected to weaken significantly.

At their November quarterly Inflation Report 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 of 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 could potentially provide fiscal stimulus to support economic growth, though at the cost of increasing the budget deficit above currently projected levels.

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 2019. 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, (on the assumption that a Brexit deal is agreed by both the UK and the EU). 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 2.1% in December 2018. 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.

As for the **labour market** figures in October**,** 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 3.3%, (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 1.2%, 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**, the Brexit deal put forward by the Conservative minority government was defeated on 15 January. It is unclear at the time of writing, how this situation will move forward. However, our central position is that Prime Minister May's government will endure, despite various setbacks, along the route to reaching an orderly Brexit though the risks are increasing that it may not be possible to get full agreement by the UK and EU before 29 March 2019, in which case this withdrawal date is likely to be pushed back to a new date. 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. The strong growth in employment numbers and the reduction in the unemployment rate to 3.9%, near to a recent 49 year low, has fed through to an upturn in wage inflation which hit 3.2% in November. However, CPI inflation overall fell to 2.2% in November and looks to be on a falling trend to drop below the Fed's target of 2% during 2019. The Fed has continued on its series of increases in interest rates with another 0.25% increase in December to between 2.25% and 2.50%, this being the fifth increase in 2018 and the ninth in this cycle. However, they did also reduce their forecast for further increases from three to two. This latest increase compounded investor fears that the Fed is over doing the speed and level of increases in rates and that it is going to cause a US recession as a result. There is also much evidence in previous monetary policy cycles of the Fed's series of increases doing exactly that. Consequently, we have seen stock markets around the world falling under the weight of fears around the Fed's actions, the trade war between the US and China and an expectation that world growth will slow.

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 if an agreement is not reached soon between the US and China.

Eurozone. Growth was 0.4% in quarters 1 and 2 but fell back to 0.2% in quarter 3, though this was 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 its 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 ended all further purchases in December 2018. The ECB is forecasting inflation to be a little below its 2% top limit through the next three years so it may find it difficult to warrant a start on raising rates by the end of 2019 if the growth rate of the EU economy is on a weakening trend.

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.** On this basis, while GDP growth is likely to be subdued in 2019 due to all the uncertainties around Brexit depressing consumer and business confidence, an agreement is likely to lead to a boost to the rate of growth in 2020 which could, in turn, increase inflationary pressures in the economy and so cause the Bank of England to resume a series of gentle increases in Bank Rate. Just how fast, and how far, those increases will occur and rise to, will be data dependent. The forecasts in this report assume a modest recovery in the rate and timing of stronger growth and in the corresponding response by the Bank in raising rates.

- 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.

However, there would appear to be a majority consensus in the Commons against any form of non-agreement exit so the chance of this occurring has now substantially diminished.

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. The EU rejected the initial proposed Italian budget and demanded cuts in government spending which the Italian government initially refused. However, a fudge was subsequently agreed, but only by *delaying* the planned increases in expenditure to a later year. This can has therefore only been kicked down the road to a later time. 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 words and actions of the Italian government and consequently, Italian bond yields have risen – 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, (a new party leader has now been elected). 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, Ireland, the 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. The Belgian coalition collapsed in December 2018 but a minority caretaker government has been appointed until the May EU wide general elections.
- **Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU while **Italy,** in 2018, 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. Throughout the last quarter of 2018, we saw sharp falls in equity markets interspersed with occasional partial rallies. 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 by 29 March a compromise that quickly removed all threats of economic and political disruption and so led to an early boost to UK economic growth.
- **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:

- 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 November 2018: EU27 leaders endorsed the withdrawal agreement.
- December 2018: Vote in UK Parliament on the agreement was postponed.
- 21 December 2018 to 8 January 2019: UK parliamentary recess.
- 15 January 2019: Brexit deal defeated in the Commons vote by a large margin.
- By 29 Mach 2019: Second vote (?) in UK parliament.
- By 29 March 2019: If the UK Parliament approves a deal, then ratification by the EU Parliament requires a simple majority.
- By 29 March 2019: If the UK and EU parliaments agree the deal, the EU Council needs to approve the deal; 20 countries representing 65% of the EU population must agree.
- 29 March 2019: Either the UK leaves the EU, or asks the EU for agreement to an extension of the Article 50 period if the UK Parliament has been unable to agree on a Brexit deal.
- 29 March 2019: 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.

5.4. Treasury Management Practice (Tmp1): Permitted Investments

This Council approves the following forms of investment instrument for use as permitted investments as set out in table 1 and table 2.

Treasury risks.

All the investment instruments in tables 1 and 2 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 / 2 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. All types of investment instrument have interest rate risk except for the following forms of instrument which are at variable rate of interest (and the linkage for variations is also shown):- (Link Asset Services note – please specify any such instruments should you use them).
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 paragraphs 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 is a 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, as a cash rich local authority the OIC 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 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 paragraph 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. All types of investment instruments.

Unlimited investments.
Regulation 24 states that an investment can be shown in tables 1 and 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 25% of the total portfolio (or £10m) can be placed with any one institution or group at any one time.
3. **The Council's Current Provider of Banking Services**. In normal circumstances the authority will ensure diversification of its portfolio ensuring that no more than 25% of the total portfolio (or £10m) can be placed with any one institution or group at any one time. In restricted circumstances, however, to be determined on a case by case basis by the Head of Finance as Section 95 Officer to the Council, the Council's banker is further authorised to hold an unlimited amount, or up to 100%, of Council funds either in the form of cash or bonds as part of the transition process or portfolio restructuring exercise for a maximum period of up to 7 working days.

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 with High Credit Worthiness Banks and Building Societies**. See paragraph 4.2 for an explanation of this authority’s definition of high credit worthiness. This is the most widely used form of investing used by local authorities. It offers a much higher rate of return than the DMADF (dependent on term). The authority will ensure diversification of its portfolio of deposits ensuring that no more than 25% of the total portfolio (or £10m) can be placed with any one institution or group. 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.
c) **Call Accounts with High Credit Worthiness Banks and Building Societies**. The objectives are as for 1b. but there is instant access to recalling cash deposited. This generally means accepting a lower rate of interest than that which could be earned from the same institution by making a term deposit. Some use of call accounts is highly desirable to ensure that the authority has ready access to cash when needed to pay bills.
d) **Fixed Term Deposits with Variable Rate and Variable Maturities (Structured Deposits)**. 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 councils with greater flexibility to adopt new instruments as and when they are brought to the market. However, this does mean that members ought to be informed as to what instruments are presently under this generic title so that they are aware of the current situation, and that they are informed and approve of intended changes in an appropriate manner.
e) **Collateralised deposits**. These are deposits placed with a bank which offers collateral backing based on specific assets. Examples seen in the past have included local authority LOBOs, where such deposits are effectively lending to a local authority as that is the ultimate security.

2. Deposits with Counterparties currently in Receipt of Government Support/Ownership.

These banks offer another dimension of creditworthiness in terms of Government backing through either partial or full direct 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) **Term deposits with high credit worthiness banks which are fully or semi nationalised**. As for 1b. but Government full, (or substantial partial), ownership, implies that the 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 that this indicates a low and acceptable level of residual risk.
b) **Fixed term deposits with variable rate and variable maturities (structured deposits).** 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 councils with greater flexibility to adopt new instruments as and when they are brought to the market. However, this does mean that members ought to be informed as to what instruments are presently covered under this generic title so that they are aware of the current situation, and that they are informed and approve of intended changes in an appropriate manner.

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) **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.
b) **Diversified Growth Fund**. This is a collective investment fund specialising in a diversified investment approach. Rather than holding individual stocks and shares a collective fund offers the advantage of more diversified investment over a wider portfolio of investments and range of asset classes. This can be attractive for authorities who want exposure to the potential for asset classes including

listed equities, private equity, high yield and investment grade bonds, structured finance, emerging market bonds, absolute return, insurance linked, commodities, infrastructure and currency assets to rise in value. By their very nature, some of these asset classes are regarded as being higher risk and as such it is not considered prudent to hold individual stocks as a direct investment. The risk profile of the collective investment fund is managed as a whole to smooth out the volatility in terms of the performance of individual investments and across asset classes.

c) **Enhanced Yield Debt or Multi Asset Credit Fund**. This is a collective investment fund specialising in enhanced yield debt focused strategies or multi asset credit investment approach. Rather than holding individual stocks and shares a collective fund offers the advantage of targeting a select group of investments and range of asset classes. This can be attractive for authorities who want exposure to the specialist area of enhanced yield debt strategies or multi asset credit asset classes including for example senior secured corporate debt, high yield, mezzanine corporate debt, property debt, infrastructure debt, asset-backed securities and distressed debt. Some of these asset classes are regarded as being both higher risk and by their nature can be more illiquid, as such it is not considered prudent to hold individual stocks as a direct investment. The risk profile of the collective investment fund is managed as a whole to smooth out the volatility in terms of the performance of individual investments and across asset classes.

Table 1: Permitted Investments in House – Common Good.

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

1.1. Deposits

	* Minimum Credit Criteria / colour banding	Liquidity risk	Market risk	Max % 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%	2 years
Term deposits – banks and building societies **	Green	term	no	100%	2 years
Fixed term deposits with variable rate and variable maturities: - Structured deposits.	Green	term	no	20%	2 years
Collateralised deposit (see note 2)	UK sovereign rating or note 1	term	no	20%	2 years

1.2. Deposits with Counterparties currently in receipt of government support/ownership.

	* Minimum Credit Criteria / colour banding	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
UK part nationalised banks	See note 1	term	no	100%	2 years
Banks part nationalised by high credit rated (sovereign rating) countries – non UK	Sovereign rating or AA- long term rating	term	no	20%	2 years
UK Government support to the banking sector (implicit guarantee)	UK sovereign rating or AA- long term rating	term	No	20%	2 years
Fixed term deposits with variable rate and variable maturities: - Structured deposits	Sovereign rating or AA- long term rating	term	yes	20%	2 years

1.3. Collective Investment Schemes Structured as Open Ended Investment Companies (OEICs).

	Minimum Fund Rating	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
1. Government Liquidity Funds	Long term AA volatility rating C2	instant	No see note A	20%	60 day weighted average
2a. Money Market Funds – Constant Net Asset Value	Long term AAA volatility rating MR1	instant	No see note A	20%	60 day weighted average
3. Ultra short dated bond funds with a credit score of 1.25	Bond fund rating	T+1 to T+5	yes	20%	90 day weighted average
4. Ultra short dated bond funds with a credit score of 1.5	Bond fund rating	T+1 to T+5	yes	20%	90 day weighted average
5. Bond Funds	Long term AA volatility rating C2	T+2 or longer	yes	20%	10 year weighted average
6. Gilt Funds	* Bond fund rating (or alternative measure if not rated)	T+2 or longer	yes	20%	10 year weighted average

1.4. Securities Issued or Guaranteed by Governments.

	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Treasury Bills	UK sovereign rating	Sale T+1	yes	20%	1 year
UK Government Gilts	UK sovereign rating	Sale T+1	yes	20%	30 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	20%	30 years
Sovereign bond issues (other than the UK govt)	AAA (or state your criteria if different)	Sale T+1	yes	20%	30 years
Bonds issued by multilateral development banks	AAA (or state your criteria if different)	Sale T+1	yes	20%	30 years

1.5. Securities Issued by Corporate Organisations.

	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Certificates of deposit issued by banks and building societies	Green	Sale T+0	yes	20%	2 year
Commercial paper other	Short-term F1, A1, P1, Long-term A, Viability C, Support 2	Sale T+0	yes	20%	90 days
Floating rate notes	Short-term F1, A1, P1, Long-term A, Viability C, Support 2	Sale T+0	yes	20%	30 years
Corporate Bonds other	Short-term F1, A1, P1, Long-term A, Viability C, Support 2	Sale T+3	yes	20%	30 years

Accounting treatment of investments. The accounting treatment may differ from the underlying cash transactions arising from investment decisions made by this Council. To ensure that the Council is protected from any adverse revenue impact, which may arise from these differences, we will review the accounting implications of new transactions before they are undertaken.

1.6. Other.

	* Minimum Credit Criteria / fund rating	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Property funds	-	T+4	yes	20%	30 years
Diversified Growth Funds	-	T+4	yes	20%	30 years
Enhanced Yield Debt Strategies or Multi Asset Fund	-	T+4	yes	20%	30 years
Local authority mortgage scheme.	* Short-term F1, A1, P1, Long-term AA-, Viability B, Support 3_			£5M	5 years

Table 2: Permitted Investments for use by external managed fund investment managers – Common Good.

2.1. Deposits.

	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Call accounts – banks and building societies	Short-term F1, A1, P1, Long-term A	instant	no	100%	On call
Term deposits – banks and building societies	* Short-term F1, A1, P1 Long-term A	term	no	100%	2 years
Collateralised deposit (see note 2)	UK sovereign rating or AA- long term rating	term	no	20%	2 years

2.2 Deposits with Counterparties Currently in Receipt of Government Support / Ownership.

	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
UK part nationalised banks	UK sovereign rating	Term or instant	no	20%	2 years
Banks part nationalised by high credit rated (sovereign rating) countries – non UK	UK sovereign rating or AA- long-term rating	Term or instant	no	20%	2 years

2.3. Collective Investment Schemes Structured as Open Ended Investment Companies (OEICs).

	* Minimum Fund Rating	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
1. Government Liquidity Funds	Long term A volatility rating C2	instant	No see note A	20%	60 days weighted average
2a. Money Market Funds – Constant Net Asset Value	Long term AA- volatility rating MR1+	instant	No see note A	20%	60 days weighted average
3. Ultra short dated bond funds with a credit score of 1.25	Long term AA- volatility rating B3	T+>1	yes	20%	90 days weighted average
4. Ultra short dated bond funds with a credit score of 1.5	Long term AA- volatility rating B3	T+>1	yes	20%	10 years weighted average
5. Bond Funds	Long term A volatility rating C2	T+>1	yes	20%	10 years weighted average
6. Gilt Funds	Long term AA volatility rating C2	T+>1	yes	20%	10 years weighted average

2.4. Securities Issued or Guaranteed by Governments.

	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Treasury Bills	UK sovereign rating	Sale T+1	yes	20%	1 year
UK Government Gilts	UK sovereign rating	Sale T+1	yes	20%	100 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	20%	100 years
Sovereign bond issues (other than the UK govt)	AAA (or state your criteria if different)	Sale T+1	yes	20%	100 years
Bonds issued by multilateral development banks	AAA (or state your criteria if different)	Sale T+1	yes	20%	100 years

2.5 Securities Issued by Corporate Organisations.

	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Certificates of deposit issued by banks and building	UK sovereign rating	Sale T+1	Yes	20%	1 year
Certificates of deposit issued by banks and building	*Short-term F1, A1, P1 Long-term A	Sale T+1	yes	20%	1 year
Commercial paper issuance covered by a specific UK Government (explicit) guarantee	UK sovereign rating	Sale T+1	Yes	20%	90 days
Commercial paper other	* Short-term F1, A1, P1, Long-term A	Sale T+1	yes	20%	90 days
Corporate Bonds issuance covered by UK Government (implicit)_	UK sovereign rating	Sale T+3	yes	20%	75 years
Corporate Bonds other	* Short-term F1, A1, P1, Long-term A,	Sale T+3	yes	20%	75 years
Other debt issuance by UK banks covered by UK Government (explicit) guarantee	UK sovereign rating	Sale T+3	Yes	20%	75 years
Floating Rate Notes	* Long-term A,	Sale T+1	yes	20%	75 years

Accounting treatment of investments. The accounting treatment may differ from the underlying cash transactions arising from investment decisions made by this Council. To ensure that the Council is protected from any adverse revenue impact, which may arise from these differences, we will review the accounting implications of new transactions before they are undertaken.

2.6 Other

	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Property funds	-	T+4	Yes	20%	30 years
Diversified Growth Funds	-	T+4	Yes	20%	30 years
Enhanced Yield Debt Strategies or Multi Asset Fund	-	T+4	Yes	20%	30 years
Infrastructure Equity	-	T+4	Yes	20%	50 years
Illiquid Debt	-	T+4	Yes	20%	30 years
Secured Income/Secured Finance		T+4	Yes	20%	30 years

It should be noted that the external fund managers appointed to manage the Council's managed fund portfolios are authorised through agreed investment guidelines to hold permitted investments in the form of non-treasury investments as described in Appendix 6 to this strategy document i.e. equity shares, unit trusts and bond holdings.

7. Permitted Investments – Non Treasury Investments.

Definition of non-treasury investments
Regulation 9 adds to the normal definition of investments the following categories:-

a. All shareholding, unit holding and bond holding, including those in a local authority owned company, is an investment.

b. Loans to a local authority company or other entity formed by a local authority to deliver services, is an investment.

c. Loans made to third parties are investments.

d. Investment property is an investment.

However, the following loans are excluded from the definition of investments:

- Loans made by a local authority to another authority or harbour authority using powers contained in Schedule 3, paragraph 10 or 11 of the Local Government (Scotland) Act 1975.

Regulation 24. A local authority shall state the limits for the amounts which, at any time during the financial year, may be invested in each type of permitted investment, such limit being applied when the investment is made. The limits may be defined by reference to a sum of money or a percentage of the local authority's overall investments, or both. A local authority may state that a permitted investment is unlimited. Where a limit is not placed on any type of permitted investment the risk assessment must support that categorisation and an explanation provided as to why an unlimited categorisation is recommended.

Regulation 25. The local authority should identify for each type of permitted investment the objectives of that type of investment. Further, the local authority should identify the treasury risks associated with each type of investment, together with the controls put into place to limit those risks. Treasury risks include credit or security risk of default, liquidity risk – the risks associated with committing funds to longer term investments and market risk – the effect of market prices on investment value.

Regulation 32. The Strategy shall include details of the maximum value and maximum periods for which funds may prudently be invested. The Strategy shall set out the local authority objectives for holding longer term investments. The Strategy shall also refer to the procedures for reviewing the holding of longer term investments particularly those investments held in properties, shareholdings in companies or joint ventures.

External fund managers appointed to manage the Council’s managed fund portfolios are authorised through agreed investment guidelines to hold permitted investments in the form of non-treasury investments as defined above i.e. equity shares, unit trusts and bond holdings.

Under current investment guidelines fund managers are authorised to hold up to 100% of the managed funds either in the form of bonds, equities, property or unit trusts including collective investment vehicles such as diversified growth and multi credit investments.

Each type of permitted investment has been detailed in Table 2 above, as part of the permitted investments for use by external cash and managed fund managers.

The Consent includes as an investment any loan issued to a local authority company or other entity formed by as local authority to deliver services, or a third party, subject to a maximum amount of £25M and a maximum duration of up to 30 years.

The Consent includes as an investment any investment property up to a maximum value of £10M per investment and a maximum duration of up to 30 years.

In such cases, individual requests will be considered by the Investment Sub-Committee as a potential investment opportunity on commercial terms in the first instance, and thereafter be the subject of due diligence exercise, if supported in principle.

Such loans and property investments are often made for service reasons and for which specific statutory provision exists. Where this is the case, the relevant Services Committee will give consideration to such requests, which may include for example loans at an interest rate below the market rate subject to the state aid implications being addressed.

All loans to third parties are classified as investments for the purposes of the Consent. Where the loan is advanced at less than a market interest rate there is an associated loss of investment return which would otherwise have been earned on these monies. Annual strategies and reports will recognise all loans to third parties as investments. In such cases, these loans will be categorised, identifying the service reason together with details of those loans carrying a below market interest rate and the impact these advances have on investment returns in future reports.

5.5. Treasury Management Practice (TMP1): Credit and Counterparty Risk Management

Orkney Islands Council, Charitable and Common Good Funds Permitted Investments, Associated Controls and Limits.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good 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.	100%, maximum 6 months.	100%, maximum 6 months.
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.	100% and maximum 2 years.	100% and maximum 2 years.
c. Money Market Funds (MMFs) (CNAV and LVNAV) **(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 MMFs has a “AAA” rated status from either Fitch, Moody’s or Standard and Poor’s.	20%	20%

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good Limits
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 issuers have an "AAA" rated status from either Fitch, Moody's or Standard and Poor's.	20%	20%
e. Call account deposit accounts with financial institutions (banks and building societies) **(Low risk depending on credit rating)**	These tend to be low risk investments, but will exhibit higher risks than categories (a), (b) and (c) above. Whilst there is no risk to value with these types of investments, liquidity is high and investments can be returned at short notice.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's Day to day investment dealing with this criteria will be further strengthened by use of additional market intelligence.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.
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) and (c) above. Whilst there is no risk to value with these types of investments, liquidity is low and term deposits can only be broken with the agreement of the counterparty, and penalties may apply.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's. Day to day investment dealing with these criteria will be further strengthened by use of additional market intelligence.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good 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.	20%, maximum 100 years.	20%, maximum 100 years.
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. Day to day investment dealing with these criteria will be further strengthened by the use of additional market intelligence.	20% and maximum 75 years.	20% and maximum 75 years.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good Limits
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) and (c) 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. Day to day investment dealing with these criteria will be further strengthened by the use of additional market intelligence.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.
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. Corporate bonds will be restricted to those meeting the base criteria. Day to day investment dealing with these criteria will be further strengthened by the use of additional market intelligence.	20% and maximum 75 years.	20% and maximum 75 years.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good Limits
Other types of investments				
a. Investment properties	These are non-service properties which are being held pending disposal or for a longer term rental income stream. These are highly illiquid assets with high risk to value (the potential for property prices to fall or for rental voids).	In larger investment portfolios some small allocation of property based investment may counterbalance/compliment the wider cash portfolio. Property holding will be re-valued regularly and reported annually with gross and net rental streams.	£5M and maximum of 30 years.	n/a
b. Loans to third parties, including soft loans	These are service investments either at market rates of interest or below market rates (soft loans). These types of investments may exhibit credit risk and are likely to be highly illiquid.	Each third party loan requires Member approval and each application is supported by the service rational behind the loan and the likelihood of partial or full default.	£5M and maximum 30 years.	n/a
c. Loans to a local authority company	These are service investments either at market rates of interest or below market rates (soft loans). These types of investments may exhibit credit risk and are likely to be highly illiquid.	Each loan to a local authority company requires Member approval and each application is supported by the service rational behind the loan and the likelihood of partial or full default.	£5M and maximum 30 years.	n/a
d. Shareholdings in a local authority company	These are service investments which may exhibit market risk and are likely to be highly illiquid.	Each equity investment in a local authority company requires Member approval and each application will be supported by the service rational behind the investment and the likelihood of loss.	100%.	n/a

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good Limits
e. 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.	Specific managed fund investment guidelines/	n/a
f. Local Authority Mortgage Scheme (LAMS)	These are service investments at market rates of interest. Under this scheme the Council would be required to place up to £5M on deposit with a participating bank for a period of between 3 to 5 years	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.	£5M and maximum 5 years.	N/a

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, and if required new counterparties which meet the criteria will be added to the list.

Use of External Fund Managers – It is the Council's policy to use external fund managers for part of its investment portfolio. The fund managers are contractually committed to keep to the Council's investment strategy. The limits for permitted investments have been established in consultation with external fund managers and are consistent with terms of their appointment. The performance of each manager is reviewed at least quarterly by the Head of Finance and the managers are contractually required to comply with the annual investment strategy.

5.6. Approved Countries for Investments

The Council has determined that it will only use approved counterparties from countries outside the UK with a minimum sovereign credit rating of AA- from Fitch Ratings (or equivalent from other agencies if Fitch does not provide). No minimum sovereign rating will be set for the UK to ensure continuity of being able to invest in UK banks/building societies.

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.

5.7. Treasury Management Scheme of Delegation

1. Full Council

- Receiving and reviewing reports on treasury management policies, practices and activities.
- Approval of annual strategy.

2. Policy and Resources Committee.

- Approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices.
- Budget consideration and approval.
- Approval of division of responsibilities.

3. Investments Sub-committee.

- Reviewing the treasury management policy and procedures and making recommendations to the responsible body.
- Receiving and reviewing regular monitoring reports and acting on recommendations.
- Approving the selection of external service providers and agreeing terms of appointment.

5.8. 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.

Equality Impact Assessment

The purpose of an Equality Impact Assessment (EqIA) is to improve the work of Orkney Islands Council by making sure it promotes equality and does not discriminate. This assessment records the likely impact of any changes to a function, policy or plan by anticipating the consequences, and making sure that any negative impacts are eliminated or minimised and positive impacts are maximised.

1. Identification of Function, Policy or Plan	
Name of function / policy / plan to be assessed.	Treasury Management Strategy Statement and Annual Investment Strategy 2019-20
Service / service area responsible.	Chief Executive's – Finance Service
Name of person carrying out the assessment and contact details.	Colin Kemp, Corporate Finance Senior Manager
Date of assessment.	05.02.19
Is the function / policy / plan new or existing? (Please indicate also if the service is to be deleted, reduced or changed significantly).	Update of existing annual strategy document

2. Initial Screening	
What are the intended outcomes of the function / policy / plan?	Approve the Council's treasury strategy, including cash flow management, capital financing and investment activities for financial year 2019/20
Is the function / policy / plan strategically important?	Yes
State who is, or may be affected by this function / policy / plan, and how.	The annual strategy sets out the parameters within which the Council is authorised to operate in managing the Council's short and long term cashflows, and including all investing and financing activities. It is considered that the efficient operation of the treasury management function, along with use a range of permitted investments and prudent borrowing limits all

	contribute towards the way Council Services are funded.
How have stakeholders been involved in the development of this function / policy / plan?	Annual revenue budget setting process, setting 5 year capital programme and review of investment strategy for Strategic Reserve Fund
Is there any existing data and / or research relating to equalities issues in this policy area? Please summarise. E.g. consultations, national surveys, performance data, complaints, service user feedback, academic / consultants' reports, benchmarking (see equalities resources on OIC information portal).	No
Is there any existing evidence relating to socio-economic disadvantage and inequalities of outcome in this policy area? Please summarise. E.g. For people living in poverty or for people of low income. See The Fairer Scotland Duty Interim Guidance for Public Bodies for further information.	No
Could the function / policy have a differential impact on any of the following equality areas?	
1. Race: this includes ethnic or national groups, colour and nationality.	No
2. Sex: a man or a woman.	No
3. Sexual Orientation: whether a person's sexual attraction is towards their own sex, the opposite sex or to both sexes.	No
4. Gender Reassignment: the process of transitioning from one gender to another.	No
5. Pregnancy and maternity.	No
6. Age: people of different	No

ages.	
7. Religion or beliefs or none (atheists).	No
8. Caring responsibilities.	No
9. Care experienced.	No
10. Marriage and Civil Partnerships.	No
11. Disability: people with disabilities (whether registered or not).	No
12. Socio-economic disadvantage.	No
13. Isles-proofing.	No

3. Impact Assessment	
Does the analysis above identify any differential impacts which need to be addressed?	No.
How could you minimise or remove any potential negative impacts?	N/A
Do you have enough information to make a judgement? If no, what information do you require?	Yes.

4. Conclusions and Planned Action	
Is further work required?	No.
What action is to be taken?	None.
Who will undertake it?	N/A
When will it be done?	N/A
How will it be monitored? (e.g. through service plans).	N/A

Signature: [redacted] Date: 05.02.19

Name: COLIN KEMP

Please sign and date this form, keep one copy and send a copy to HR and Performance. A Word version should also be emailed to HR and Performance at hrsupport@orkney.gov.uk