

Item: 5

Policy and Resources Committee: 1 March 2022.

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 2022/23.

2. Recommendations

It is recommended:

That the Treasury Management Strategy Statement and Annual Investment Strategy for 2022/23, attached as Appendix 1 to this report, be approved.

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 investment activities so as to be able to meet 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 2022/23, attached as Appendix 1 to this report, are summarised as follows:

4.8.1.

The key issue now is the huge damage the coronavirus pandemic has done to the UK and all economies around the world, and how these economies will continue to recover in 2022.

4.8.2.

Concerns regarding the effect of the Omicron variant have largely disappeared by the meeting of the Bank of England in February 2022, where a decision was taken to increase base-rate by 0.25% to 0.50%. This increase is predicted to be followed by an increase to 1.0% in May and 1.25% in November 2022, with the current focus on controlling inflation rates over the medium term rather than protecting economic growth over the short term.

4.8.3.

The counterparty limit for the Council's treasury management, or cash balances, is 25% 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.

4.8.4.

Inflation is predicted to reach 7.25% by April 2022, well in excess of the long-term Bank of England inflation target of 2%.

4.8.5.

The Annual Investment Strategy has been updated to reflect the annual review of the Strategic Reserve Fund which was recommended for approval by the Policy and Resources Committee on 21 December 2021, as part of the budget setting process for 2022/23.

4.8.6.

The Council's existing capital programme includes approved capital project expenditure of £57,793,000 over the 3 year period 2022 to 2025 which, after allowing for £27,977,000 use of reserves, leaves an identified capital financing borrowing requirement of £29,816,000.

4.8.7.

The Council's net capital financing requirement is forecast to increase from £53,161,000 to £70,635,000 over the 3 year period from 2022 to 2025, being a net increase of £17,474,000 after allowing for the repayment of principal.

4.8.8.

In terms of core funds and expected investment balances, the Council's resources and anticipated cash flow balances are forecast to increase by £20,380,000, from £303,544,000 to £323,924,000, over the 3 year period 2022 to 2025.

4.9.

The affordability of the capital programme relative to the Council's overall finances over the 3 year period 2022 to 2025 can be measured as the ratio of cost of capital, or loan charges, relative to net revenue stream, as follows:

- General Fund Services – 0.7% increasing to 1.2%.
- Scapa Flow Oil Port – 18.2% increasing to 22.3%.
- Miscellaneous Piers – 20.1% decreasing to 14.3%.
- Housing Revenue Account – 19.0% decreasing to 14.9%.

4.10.

While the ratio for General Fund Services is considered to be relatively low, with an increase of 0.5% over the period to 1.2%, this can be attributed directly to the Council's past policy of accelerating debt repayments.

4.11.

The Housing Revenue Account is forecast to reduce by 5.8% to 14.3%, which can also be attributed to previous debt acceleration. However, it should be noted that the current capital programme does not include proposed projects for which Stage 2 Capital Project Appraisals remain outstanding.

4.12.

The increase on the cost of capital being incurred by Scapa Flow Oil Port, from 18.2% to 22.3%, is equivalent to almost one 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 three new tugs.

4.13.

The Council's authorised limit for external debt is scheduled to increase from £75,000,000 to £85,000,000 over the 3 year period 2022 to 2025 and the operational boundary for external debt also increasing from £65,000,000 to £70,000,000 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 and 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 £35,000,000 as at 31 March 2021, the Head of Finance would be authorised to respond to favourable movements in the financial markets and effect additional borrowing of up to £35,000,000.

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.

In terms of Section 1 of the Local Government in Scotland Act 2003, 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 (Scotland) 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 2022/23.

Appendix 2: Equality Impact Assessment.

**Treasury Management Strategy
Statement
and Annual Investment Strategy**

Orkney Islands Council
2022/2023

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1 Introduction

1.1 Background

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

The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer-term cash flow planning, to ensure that the Council can meet its capital spending obligations. This management of longer-term cash may involve arranging long or short-term loans or using longer-term cash flow surpluses. On occasion, when it is prudent and economic, 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 commercial initiatives or loans to third parties will impact on the treasury function, these activities are generally classed as non-treasury activities, arising mainly from investing activities of the Strategic Reserve Fund, 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, including its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

1.2 Reporting requirements

1.2.1 Capital Strategy

The CIPFA 2021 Prudential and Treasury Management Codes require all local authorities to prepare a capital strategy report which will provide the following:

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

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

1.2.2 Treasury Management reporting

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

- a. Prudential and treasury indicators and treasury strategy** (this report) - The first, and most important report 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 on 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 2022/23

The strategy for 2022/23 covers two main areas:

Capital issues

- the capital expenditure plans and the associated prudential indicators.
- the loans fund repayment policy.

Treasury management issues

- the current treasury position.
- treasury indicators which limit the treasury risk and activities of the Council.
- prospects for interest rates.
- the borrowing strategy.
- policy on borrowing in advance of need.

- debt rescheduling.
- the investment strategy.
- creditworthiness policy, and
- the 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 taken training during 2022/2022 and further training will be arranged as required.

The training needs of treasury management officers are periodically reviewed.

1.5 Treasury management consultants

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

The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon 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, documented and subjected to regular review.

2 The Capital Prudential Indicators 2022/23 – 2024/25

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 2022:

Capital expenditure £m	2020/21 Actual	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate
Non-HRA	14.099	12.516	28.701	17.079	5.676
HRA	2.359	2.693	5.681	0.656	0.000
Total	16.458	15.209	34.382	17.735	5.676

Other long-term liabilities - the above financing need excludes other long-term liabilities, such as PFI and leasing arrangements that 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	2020/21 Actual	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate
Capital receipts	1.167	0.150	0.150	0.150	0.150
Capital grants	6.886	9.023	9.260	5.000	5.000
Capital reserves	0.593	1.814	6.448	1.481	0.000
Revenue	0.199	0.849	1.009	0.599	0.569
Net financing need for the year	8.845	11.836	16.867	7.230	5.719

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 indebtedness and so its 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. From 1.4.16, authorities may choose whether to use scheduled debt amortisation, (loans pool charges), or another suitable method of calculation in order to repay borrowing.

The CFR includes any other long-term liabilities (e.g., PFI schemes, finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of schemes 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	2020/21 Actual	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate
Capital Financing Requirement					
CFR – non housing	42.095	42.299	55.538	63.090	60.432
CFR – housing	9.737	10.862	10.401	10.596	10.203
Total CFR	51.832	53.161	65.939	73.686	70.635
Movement in CFR	1.276	1.329	12.778	7.747	(3.051)

Movement in CFR represented by					
Net financing need for the year (above)	7.613	3.373	14.930	10.505	(0.043)
Less loan fund repayments and other financing movements	(6.337)	(2.044)	(2.152)	(2.758)	(3.008)
Movement in CFR	1.276	1.329	12.778	7.747	(3.051)

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	2020/21 Actual	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate
Strategic Reserve Fund	233.717	245.135	246.913	251.178	259.639
Other Fund balances / reserves	35.915	35.900	35.900	35.900	35.900
Capital receipts	2.539	2.500	2.500	2.500	2.500
Provisions	31.004	32.585	33.954	34.973	36.022
Other	10.742	10.700	10.700	10.700	10.700
Total core funds	313.917	326.820	329.967	335.251	344.761
Working capital*	(5.119)	(5.200)	(5.200)	(5.200)	(5.200)
Under/over borrowing**	(16.718)	(18.076)	(20.883)	(18.659)	(15.637)
Expected investments	292.080	303.544	303.884	311.392	323.924

*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 2022/23:

For all loan 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 an 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 2021 and for the position as at 31 December 2021 are shown below for both borrowing and investments, including the Strategic Reserve Fund investments managed in-house and externally.

TREASURY PORTFOLIO				
	actual	actual	current	current
	31.3.21	31.3.21	31.12.21	31.12.21
Treasury investments	£000	%	£000	%
banks	19,682	6%	13,986	4%
building societies - unrated	0	0%	0	0%
building societies - rated	0	0%	0	0%
local authorities	5,000	2%	3,000	1%
DMADF (H.M.Treasury)	0	0%	0	0%
money market funds	4,300	1%	3,900	1%
certificates of deposit	6,000	2%	9,000	3%
Total managed in house	34,982	11%	29,886	9%
property investments	19,800	6%	19,800	6%
local investments	8,736	3%	8,736	3%
Strategic Reserve Fund managed in house	28,536	9%	28,536	8%
bond funds	55,212	17%	46,792	14%
diversified growth fund	44,061	14%	46,237	14%
equity fund	106,361	33%	112,453	33%
credit strategies fund	22,167	7%	22,879	7%
property funds	23,046	7%	26,115	8%
global private debt fund	7,683	2%	8,964	3%
alternative income fund	0	0%	15,239	5%
Strategic Reserve Fund managed externally	258,530	80%	278,679	83%
Total treasury investments	322,048	100%	337,101	100%

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

£m	2020/21	2021/22	2022/23	2023/24	2024/25
	Actual	Estimate	Estimate	Estimate	Estimate
External Debt					
Debt at 1 April	30.143	35.114	35.085	45.056	55.027
Expected change in Debt	(0.029)	(0.029)	9.971	9.971	(0.029)
Other long-term liabilities (OLTL)	0.000	0.000	0.000	0.000	0.00
Expected change in OLTL	0.000	0.000	0.000	0.000	0.000
Actual gross debt at 31 March	35.114	35.085	45.056	55.027	54.998
The Capital Financing Requirement	51.832	53.161	65.939	73.686	70.635
Under / (over) borrowing	16.718	18.076	20.883	18.659	15.637

Within the range of prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well-defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2022/23 and the following two financial years. This allows some flexibility for limited early borrowing for future years but ensures that borrowing is not undertaken for revenue or speculative 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	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate
Debt	65.000	65.000	70.000	70.000
Other long-term liabilities	0.000	0.000	0.000	0.000
Total	65.000	65.000	70.000	70.000

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.

- a) The authorised limits for external debt for the current year and two subsequent years are the legislative limits determined under Regulation 6(1) of the Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016.
- b) The Council is asked to approve the following authorised limit:

Authorised limit £m	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate
Debt	75.000	75.000	85.000	85.000
Other long-term liabilities	0.000	0.000	0.000	0.000
Total	75.000	75.000	85.000	85.000

3.3 Prospects for interest rates

The Council has appointed Link Group as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. Link provided the following forecasts on 7 February 2022. These are forecasts for certainty rates, gilt yields plus 80bps:

Link Group Interest Rate View		7.2.22											
	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25
BANK RATE	0.75	1.00	1.00	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
3 month av. earnings	0.80	1.00	1.00	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20
6 month av. earnings	1.00	1.10	1.20	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30
12 month av. earnings	1.40	1.50	1.60	1.70	1.70	1.60	1.60	1.50	1.40	1.40	1.40	1.40	1.40
5 yr PWLB	2.20	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30
10 yr PWLB	2.30	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40
25 yr PWLB	2.40	2.50	2.50	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60
50 yr PWLB	2.20	2.30	2.30	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40

Additional notes by Link on this forecast table: -

- LIBOR and LIBID rates ceased at the end of 2021. In a continuation of our previous forecasts, our money market yield forecasts are based on expected average earnings by local authorities for 3 to 12 months.
- Our forecasts for average earnings are averages i.e., rates offered by individual banks may differ significantly from these averages, reflecting their different needs for borrowing short term cash at any one point in time.

Over the last two years the coronavirus outbreak has done huge economic damage to the UK and to economies around the world. After the Bank of England took emergency action in March 2020 to cut Bank Rate to 0.10%, it left Bank Rate unchanged at its subsequent meetings until raising it to 0.25% at its meeting on 1 December 2021 and then to 0.50% at its meeting of 4 February 2022.

As shown in the forecast table above, the forecast for Bank Rate now includes a further three increases of 0.25%, in March, May and November 2022 to end at 1.25%.

Significant risks to the forecasts

- Mutations of the virus render current vaccines ineffective, and tweaked vaccines to combat these mutations are delayed, or cannot be administered fast enough to prevent further lockdowns.
- Labour and supply shortages prove more enduring and disruptive and depress economic activity.
- The Monetary Policy Committee acts too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- The Monetary Policy Committee tightens monetary policy too late to ward off building inflationary pressures.
- The Government acts too quickly to cut expenditure to balance the national budget.

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

The balance of risks to the UK economy: -

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

Forecasts for Bank Rate

The Monetary Policy Committee is now very concerned at the way that forecasts for inflation have had to be repeatedly increased within a matter of just a few months. Combating this rising tide of inflation is now its number one priority and the 5-4 vote marginally approving only a 0.25% increase on 4th February rather than a 0.50% increase, indicates it is now determined to push up Bank Rate quickly. A further increase of 0.25% is therefore probable for March, and again in May, followed possibly by a final one in November. However, data between now and November could shift these timings or add to or subtract from the number of increases.

- We do not know whether there will be further mutations of Covid and how severe they may be, nor how rapidly scientific advances may be made in combating them.
- The economy was running out of steam during the second half of 2021 and Omicron will mean that economic growth in quarter 1 of 2022 is likely to be flat, though on the rise towards the end of the quarter as the economy recovers. However, 54% energy cap cost increases from April, together with 1.25% extra employee national insurance, food inflation around 5% and council tax likely to rise in the region of 5% too – these increases are going to hit lower income families hard despite some limited assistance from the Chancellor to postpone the full impact of rising energy costs.
- Consumers are estimated to be sitting on over £160bn of excess savings left over from the pandemic so that will cushion some of the impact of the above increases. But most of those holdings are held by more affluent people whereas poorer people already spend nearly all their income before these increases hit and have few financial reserves.
- These increases are already highly disinflationary; inflation will also be on a gradual path down after April so that raises a question as to whether the MPC

may shift into protecting economic growth by November, i.e., it is more debatable as to whether they will deliver another increase then.

- The BIG ISSUE – will the current spike in inflation lead to a second-round effect in terms of labour demanding higher wages, (and/or lots of people getting higher wages by changing job)?
- If the labour market remains very tight during 2022, then wage inflation poses a greater threat to overall inflation being higher for longer, and the MPC may then feel it needs to take more action.
- If the UK were to invoke article 16 of the Brexit deal over the dislocation in trading arrangements with Northern Ireland, this would have the potential to end up in a no-deal Brexit.

In summary, with the high level of uncertainty prevailing on several different fronts, we expect to have to revise our forecasts again - in line with whatever the new news is.

Forecasts for PWLB rates and gilt and treasury yields

Gilt yields. Since the start of 2021, we have seen a lot of volatility in gilt yields, and hence PWLB rates. Our forecasts show little overall increase in gilt yields during the forecast period, to March 2025, but there will doubtless be a lot of unpredictable volatility during this forecast period.

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

US treasury yields. During the first part of 2021, US President Biden's, and the Democratic party's, determination to push through a \$1.9trn (equivalent to 8.8% of GDP) fiscal boost for the US economy as a recovery package from the Covid pandemic was what unsettled financial markets. This was in addition to the \$900bn support package previously passed in December 2020. Financial markets were alarmed that all this stimulus was happening at a time when: -

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

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

- At its 3rd November Fed meeting, the Fed decided to make a start on tapering . its \$120bn per month of QE purchases so that they ended next June. However, at its 15th December meeting it doubled the pace of tapering so that they will end all purchases in February. These purchases are currently acting as downward pressure on treasury yields and so it would be expected that Treasury yields will rise over the taper period, all other things being equal.
- It is also forecast that it expected there would be three rate rises in 2022 of 0.25% from near zero currently, followed by three in 2023 and two in 2024. This would take rates back above 2% to a neutral level for monetary policy. It also gave up on calling the sharp rise in inflation as being 'transitory'.
- At its 26th January meeting, the Fed became even more hawkish following inflation rising sharply even further. It indicated that rates would begin to rise very soon, i.e., it implied at its March meeting it would increase rates and start to run down its holdings of QE purchases. It also appears likely that the Fed could take action to force longer term treasury yields up by prioritising selling holdings of its longer bonds as yields at this end have been stubbornly low despite rising inflation risks. The low level of longer dated yields is a particular concern for the Fed because it is a key channel through which tighter monetary policy is meant to transmit to broader financial conditions, particularly in the US where long rates are a key driver of household and corporate borrowing costs.

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

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

- How strongly will changes in gilt yields be correlated to changes in US treasury yields (see below). As the US financial markets are, by far, the biggest financial markets in the world, any upward trend in treasury yields will invariably impact and influence financial markets in other countries. Over 10 years since 2011 there has been an average 75% correlation between movements in US treasury yields and gilt yields. However, from time to time these two yields can diverge. Lack of spare economic capacity and rising inflationary pressures are viewed as being much greater dangers in the US than in the UK. This could mean that central bank rates will end up rising higher in the US than in the UK; the consequent increases in treasury yields could well spill over to cause (lesser) increases in gilt yields. There is, therefore, an upside risk to forecasts for gilt yields due to this correlation. The

Link Group forecasts have included a risk of a 75% correlation between the two yields.

- Will the Fed take action to counter increasing treasury yields if they rise beyond a yet unspecified level?
- Would the MPC act to counter increasing gilt yields if they rise beyond a yet unspecified level?
- How strong and enduring will inflationary pressures turn out to be in both the US and the UK and so impact treasury and gilt yields?
- **Will the major western central banks implement their previously stated new average or sustainable level inflation monetary policies when inflation has now burst through all previous forecasts and far exceeded their target levels? Or are they going to effectively revert to their previous approach of prioritising focusing on pushing inflation back down and accepting that economic growth will be very much a secondary priority - until inflation is back down to target levels or below?**
- How well will central banks manage the running down of their stock of QE purchases of their national bonds i.e., without causing a panic reaction in financial markets as happened in the “taper tantrums” in the US in 2013?
- Will exceptional volatility be focused on the short or long-end of the yield curve, or both?
- If Russia were to invade Ukraine, this would be likely to cause short term volatility in financial markets, but it would not be expected to have a significant impact beyond that.

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

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

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

A new era for local authority investing – a fundamental shift in central bank monetary policy

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

- The Fed in America has gone furthest in adopting a monetary policy based on a clear goal of allowing the inflation target to be symmetrical, (rather than a

ceiling to keep under), so that inflation averages out the dips down and surges above the target rate, over an unspecified period of time.

- The Bank of England has also amended its target for monetary policy so that inflation should be 'sustainably over 2%' before starting on raising Bank Rate and the ECB now has a similar policy.
- **For local authorities, this means that investment interest rates and very short term PWLB rates will not be rising as high as in previous decades when the economy recovers from a downturn and the recovery eventually runs out of spare capacity to fuel continuing expansion.**
- Labour market liberalisation since the 1970s has helped to break the wage-price spirals that fuelled high levels of inflation and has now set inflation on a lower path which makes this shift in monetary policy practicable. In addition, recent changes in flexible employment practices, the rise of the gig economy and technological changes, will all help to lower inflationary pressures once economies recover from the various disruptions caused by the pandemic.
- Governments will also be concerned to see interest rates stay lower as every rise in central rates will add to the cost of vastly expanded levels of national debt; (in the UK this is £21bn for each 1% rise in rates). On the other hand, higher levels of inflation will help to erode the real value of total public debt.

Investment and borrowing rates

- **Investment returns** have started improving in the second half of 21/22 and are expected to improve further during 22/23 as the MPC progressively increases Bank Rate.
- **Borrowing interest rates** fell to historically very low rates as a result of the COVID crisis and the quantitative easing operations of the Bank of England and still remain at historically low levels. The policy of avoiding new borrowing by running down spare cash balances has served local authorities well over the last few years.
- On 25.11.20, the Chancellor announced the conclusion to the review of margins over gilt yields for PWLB rates which had been increased by 100 bps in October 2019. The standard and certainty margins were reduced by 100 bps but a prohibition was introduced to deny access to borrowing from the PWLB for any local authority which had purchase of assets for yield in its three-year capital programme. The current margins over gilt yields are as follows:
 - **PWLB Standard Rate** is gilt plus 100 basis points (G+100bps)
 - **PWLB Certainty Rate** is gilt plus 80 basis points (G+80bps)
 - **PWLB HRA Standard Rate** is gilt plus 100 basis points (G+100bps)
 - **PWLB HRA Certainty Rate** is gilt plus 80bps (G+80bps)
 - **Local Infrastructure Rate** is gilt plus 60bps (G+60bps)
- **Borrowing for capital expenditure.** Our long-term (beyond 10 years) forecast for Bank Rate is 2.00%. As nearly all PWLB certainty rates are now above this level, borrowing strategy will need to be reviewed, especially as the maturity curve has flattened out considerably. Better value can be obtained at

the very short and at the longer end of the curve and longer-term rates are still at historically low levels. Temporary borrowing rates are likely, however, to remain near Bank Rate and may also prove attractive as part of a balanced debt portfolio. In addition, there are also some cheap alternative sources of long-term borrowing if a client is seeking to avoid a “cost of carry” but also wishes to mitigate future re-financing risk.

- While this authority will not be able to avoid borrowing to finance new capital expenditure, to replace maturing debt and the rundown of reserves, there will be a *cost of carry*, (the difference between higher borrowing costs and lower investment returns), to any new borrowing that causes a temporary increase in cash balances.

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 that needs to be considered.

Against this background and the risks within the economic forecast, caution will be adopted with the 2022/23 treasury 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 borrowing rates*, then borrowing will be postponed.
- *if it was felt that there was a significant risk of a much sharper RISE in borrowing 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 sums 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

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

If rescheduling was done, it 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 following:-

- Local Government Investments (Scotland) Regulations 2010, (and accompanying Finance Circular 5/2010),
- CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2021 (“the Code”)
- CIPFA Treasury Management Guidance Notes 2021

The Council's investment priorities will be security first, portfolio liquidity second and then yield, (return). The Council will aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity and with the Council's risk appetite. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs. However, where appropriate (from an internal as well as external perspective), the Council will also consider the value available in periods up to 12 months with high credit rated financial institutions.

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

1. 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.
2. **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.
3. **Other information sources** used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.
4. This authority has defined the list of **types of investment instruments** that are permitted investments authorised for use in appendix 5.4. Appendix 5.5 expands on the risks involved in each type of investment and the mitigating controls.
5. **Lending limits**, (amounts and maturity), for each counterparty will be set through applying the matrix table in paragraph 4.2.
6. **Transaction limits** are set for each type of investment in appendix 5.4.
7. This authority will set a limit for the amount of its investments which are invested for **longer than 365 days**, (see paragraph 4.4).

8. Investments will only be placed with counterparties from countries with a specified minimum **sovereign rating**, (see paragraph 4.3).
9. 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.
10. All investments will be denominated in **sterling**.
11. As a result of the change in accounting standards for 2022/23 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. 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.
12. As a result of the change in accounting standards for 2022/23 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. Orkney Islands Council investments mainly sit on the Strategic Reserve Fund, meaning that the General Fund is largely unaffected by the changes to this accounting standard.
13. 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.

Following a review of the investment strategy work is ongoing to achieve further diversification away from equity investments, into more illiquid longer-term alternative asset classes including illiquid debt and secured income/finance.

4.2 Creditworthiness policy

This Council applies the creditworthiness service provided by the Link Group. 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 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 equivalent) 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. 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

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

government.

* Please 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 5.5.

Creditworthiness.

Significant levels of downgrades to Short- and Long-Term credit ratings have not materialised since the crisis in March 2020. In the main, where they did change, any alterations were limited to Outlooks. However, as economies are beginning to reopen, there have been some instances of previous lowering of Outlooks being reversed.

CDS prices

Although bank CDS prices, (these are market indicators of credit risk), spiked upwards at the end of March / early April 2020 due to the heightened market uncertainty and ensuing liquidity crisis that affected financial markets, they have returned to more average levels since then. However, sentiment can easily shift, so it will remain important to undertake continual monitoring of all aspects of risk and return in the current circumstances. Link monitor CDS prices as part of their creditworthiness service to local authorities and the Council has access to this information via its Link-provided Passport portal.

4.3 Other 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. The 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.

The current forecast shown in paragraph 3.3, includes a forecast for Bank Rate to reach 1.25% in November 2022.

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:

Average earnings in each year	Now	Previously
2022/23	1.00%	0.50%
2023/24	1.25%	0.75%
2024/25	1.25%	1.00%
2025/26	1.25%	1.25%
Years 6 to 10	1.50%	-
Years 10+	2.00%	2.00%

Against this view the Treasury officers expect for its cash flow generated balances, the Council will seek to utilise its business reserve instant access and notice accounts, money market funds, short-dated deposits (overnight to 100 days) and long-dated deposits (up to 365 days), in order to benefit from the compounding of interest.

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 following treasury indicator and limit:

Upper limit for principal sums invested for longer than 365 days			
£m	2022/23	2023/24	2024/25
Principal sums invested for longer than 365 days	£m 75	£m 75	£m 75
Current investments as at 31 December 21 in excess of 1 year maturing in each year	Nil	Nil	Nil

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. Since then, a further review has taken place which has resulted in the adoption of an income focused strategy in 2019. Both these changes in strategy are reflected in the forecast for the next three years as follows:

- 2020/2021 5.60%.
- 2021/2022 5.20%.
- 2022/2023 5.20%.

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 performance / risk benchmarking

This Council will use an investment benchmark to assess the investment performance of its investment portfolio for both in-house and external investments:

Investment Portfolio	Benchmark	Target Mandate
In-house cash balances	90-day LIBOR	Outperform benchmark
Bonds	UK Corporate Bonds – Market Iboxx Sterling Non-Gilts ex BBB	Benchmark over a rolling 3-year period
Equities	Global Equities - MSCI All Country World Index (NDR)	Benchmark over a rolling 3-year period +1.5% p.a.
Equities – Global Alpha	FTSE All Share (9%), MSCI All County World Index (49%), UK Base Rate (27%), FTSE Act (15%)	Outperform benchmark over a rolling 3-year period
UK Property Fund	MSCI 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.
High Yield Debt Strategies	90-day LIBOR	Benchmark over a rolling 3-year period +5.0% p.a.
Secured Income Fund	10 Year Gilts	Benchmark over a rolling 3-year period +2.0% p.a.
Global Private Debt Fund	90-day LIBOR	Benchmark over a rolling 3-year period +6.0% p.a.

The Council appreciates that the provision of LIBOR and associated LIBID rates ceased at the end of 2021. It will work with its advisors in determining suitable replacement investment benchmark(s) and will report back to members accordingly.

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 2022, it is estimated that £226.8m of the Council's funds will be externally managed on a discretionary by externally appointed fund managers.

A review of the investment strategy for the Councils 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 to improve the risk

and return profile of the fund through the use of specialist pooled funds to diversify away from Equities as an asset class.

In 2018 the Investment Sub-Committee reviewed the investment strategy again and on 28 February 2019 resolved to further diversify into Illiquid Debt and Secured Income by way of direct investment to a pooled fund. It was further resolved that the equity allocation be split on a 50/50 basis between funds held on a growth basis, with a newly appointed Fund Manager, whilst retaining Schroders on a simplified single global equity strategy with the existing value style basis. The Corporate Bonds allocation will be transferred to a specialist passive manager. These diversifications will be matched by a proportionate reduction in growth assets.

The Head of Finance developed an Action Plan, in consultation with Hymans Robertson, to commence the process of implementation of the changes to the investment strategy. Interviews with potential fund managers took place in August and October 2019 after which fund managers were appointed to three new mandates, as follows:

- Baillie Gifford – Global Alpha.
- Barings – Global Private Loan Fund III.
- Blackrock – UK Strategic Alternative Income Fund.

In addition to the above appointments, Legal and General Investment Managers were appointed through a national framework to manage the bond allocation for the Strategic Reserve Fund on a passive basis.

The process to put the new mandates in place commenced in 2019 but has not concluded yet due to Covid-19 related volatility being experienced in the markets.

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 on 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.

5 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 2022/23 – 2024/25

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	2020/21 Actual	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate
Social Care	0.077	0.150	6.150	6.539	0.000
Roads and Transportation	1.412	2.218	3.018	1.300	0.950
Education and Leisure	1.120	4.110	3.613	0.078	0.000
Marine Services	7.611	1.785	10.405	5.572	1.136
Other Services	3.879	4.253	5.515	3.590	3.590
Non-HRA	14.099	12.516	28.701	17.079	5.676
HRA	2.359	2.693	5.681	0.656	0.000
Total	16.458	15.209	34.382	17.735	5.676

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:

a. 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.

%	2020/21 Actual	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate
General Fund	1.1%	0.7%	0.7%	1.1%	1.2%
Scapa Flow Oil Port	13.5%	18.2%	17.1%	22.5%	22.3%
Miscellaneous Piers	8.1%	20.1%	14.9%	12.4%	14.3%
Housing Revenue Account	21.8%	19.0%	18.0%	17.1%	14.9%

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

The above ratio for the Housing Revenue Account shows the amount of rent income being committed to servicing the long-term debt associated with the Council's house building strategy 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.

HRA ratios

£	2020/21 Actual	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate
HRA debt £m	9.737	10.862	10.401	10.596	10.203
HRA revenues £m	3.850	3.935	4.186	4.398	4.546
Ratio of debt to revenues %	39.5	36.2	40.2	41.5	44.5

£	2020/21 Actual	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate
HRA debt £m	9.737	10.862	10.401	10.596	10.203
Number of HRA dwellings £m	946	982	1014	1028	1028
Debt per dwelling £	10,293	11,061	10,257	10,307	9,925

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 2022/23		
	Lower	Upper
Under 12 months	15%	10%
12 months to 2 years	0%	0%
2 years to 5 years	0%	0%
5 years to 10 years	0%	0%
10 years to 20 years	0%	0%
20 years and above	85%	90%

5.1.4. Control of interest rate exposure

Please see paragraphs 3.3, 3.4 and 4.4.

5.2 Interest Rate Forecasts 2022-2025

PWLB forecasts are based on PWLB certainty rates.

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

Link Group Interest Rate View 7.2.22													
	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25
BANK RATE	0.75	1.00	1.00	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
3 month av. earnings	0.80	1.00	1.00	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20
6 month av. earnings	1.00	1.10	1.20	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30
12 month av. earnings	1.40	1.50	1.60	1.70	1.70	1.60	1.60	1.50	1.40	1.40	1.40	1.40	1.40
5 yr PWLB	2.20	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30
10 yr PWLB	2.30	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40
25 yr PWLB	2.40	2.50	2.50	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60
50 yr PWLB	2.20	2.30	2.30	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40
Bank Rate													
Link	0.75	1.00	1.00	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
Capital Economics	0.50	0.75	1.00	1.25	1.25	1.25	1.25	1.25	-	-	-	-	-
5yr PWLB Rate													
Link	2.20	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30
Capital Economics	2.00	2.10	2.10	2.20	2.20	2.30	2.40	2.40	-	-	-	-	-
10yr PWLB Rate													
Link	2.30	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40
Capital Economics	2.20	2.20	2.20	2.30	2.30	2.40	2.50	2.50	-	-	-	-	-
25yr PWLB Rate													
Link	2.40	2.50	2.50	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60
Capital Economics	2.40	2.40	2.50	2.60	2.60	2.70	2.80	2.90	-	-	-	-	-
50yr PWLB Rate													
Link	2.20	2.30	2.30	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40
Capital Economics	2.10	2.20	2.30	2.40	2.50	2.60	2.70	2.90	-	-	-	-	-

5.3 Economic Background

COVID-19 and vaccines.

These were the game changer during 2021 which raised high hopes that life in the UK would be able to largely return to normal in the second half of the year. However, the bursting onto the scene of the Omicron mutation at the end of November, rendered the initial two doses of all vaccines largely ineffective in preventing infection. This dashed such hopes and raised major concerns that a fourth wave of the virus could overwhelm hospitals in early 2022. What we now know is that although this mutation is very fast spreading, it does not cause severe illness in fully vaccinated people. Rather than go for full lockdowns which heavily damage the economy, the government strategy this time focused on getting as many people as possible to have a third (booster) vaccination after three months from the previous last injection., It also placed restrictions on large indoor gatherings and hospitality venues over Christmas and into January and requested workers to work from home. This hit sectors like restaurants, travel, tourism and hotels hard which had already been hit hard during 2021. Economic growth will also have been lower due to people being ill and not working, similar to the pingdemic in July. The economy, therefore, faces significant headwinds in early 2022 although some sectors have learned how

to cope well with Covid. The big question still remains as to whether any further mutations of this virus could develop which render all current vaccines ineffective, as opposed to how quickly vaccines can be modified to deal with them and enhanced testing programmes be implemented to contain their spread until tweaked vaccines become widely available.

A SUMMARY OVERVIEW OF THE FUTURE PATH OF BANK RATE

- The threat from Omicron was a wild card causing huge national concern at the time of December's MPC meeting; now it is seen as a vanquished foe disappearing in the rear-view mirror.
- The MPC shifted up a gear last week in raising Bank Rate by another 0.25% and narrowly avoiding making it a 0.50% increase by a 5-4 voting margin.
- Our forecast now expects the MPC to deliver another 0.25% increase in March; their position appears to be to go for sharp increases to get the job done and dusted.
- The March increase is likely to be followed by an increase to 1.0% in May and then to 1.25% in November.
- The MPC is currently much more heavily focused on combating inflation than on protecting economic growth.
- However, 54% energy cap cost increases from April, together with 1.25% extra employee national insurance, food inflation around 5% and council tax likely to rise in the region of 5% too - these increases are going to hit lower income families hard despite some limited assistance from the Chancellor to postpone the full impact of rising energy costs.
- Consumers are estimated to be sitting on over £160bn of excess savings left over from the pandemic so that will cushion some of the impact of the above increases. But most of those holdings are held by more affluent people whereas poorer people already spend nearly all their income before these increases hit and have few financial reserves.
- The increases are already highly disinflationary; inflation will also be on a gradual path down after April so that raises a question as to whether the MPC may shift into protecting economic growth by November, i.e., it is more debatable as to whether they will deliver another increase then.
- The BIG ISSUE – will the current spike in inflation lead to a second-round effect in terms of labour demanding higher wages, (and/or lots of people getting higher wages by changing job)?
- If the labour market remains very tight during 2022, then wage inflation poses a greater threat to overall inflation being higher for longer, and the MPC may then feel it needs to take more action.

PWLB RATES

- The yield curve has flattened out considerably.
- We view the markets as having built in, already, nearly all the effects on gilt yields of the likely increases in Bank Rate.
- It is difficult to say currently what effect the Bank of England starting to sell gilts will have on gilt yields once Bank Rate rises to 1%: it is likely to act

cautiously as it has already started on not refinancing maturing debt. A passive process of not refinancing maturing debt could begin in March when the 4% 2022 gilt matures; the Bank owns £25bn of this issuance. A pure roll-off of the £875bn gilt portfolio by not refinancing bonds as they mature, would see the holdings fall to about £415bn by 2031, which would be about equal to the Bank's pre-pandemic holding. Last August, the Bank said it would not actively sell gilts until the "Bank Rate had risen to at least 1%" and, "depending on economic circumstances at the time."

- It is possible that Bank Rate will not rise above 1% as the MPC could shift to relying on quantitative tightening (QT) to do the further work of taking steam out of the economy and reducing inflationary pressures.
- Increases in US treasury yields over the next few years could add upside pressure on gilt yields though, more recently, gilts have been much more correlated to movements in bund yields than treasury yields.

MPC MEETING 4TH FEBRUARY 2022

- After the Bank of England became the first major western central bank to put interest rates up in this upswing in December, it has quickly followed up its first 0.15% rise by another 0.25% rise to 0.50%, in the second of what is very likely to be a series of increases during 2022.
- The Monetary Policy Committee voted by a majority of 5-4 to increase Bank Rate by 25bps to 0.5% with the minority preferring to increase Bank Rate by 50bps to 0.75%. The Committee also voted unanimously for the following:
 - to reduce the £875n stock of UK government bond purchases, financed by the issuance of central bank reserves, by ceasing to reinvest maturing assets.
 - to begin to reduce the £20bn stock of sterling non-financial investment-grade corporate bond purchases by ceasing to reinvest maturing assets and by a programme of corporate bond sales to be completed no earlier than towards the end of 2023.
- The Bank again sharply increased its forecast for inflation – to now reach a peak of 7.25% in April, well above its 2% target.
- The Bank estimated that UK GDP rose by 1.1% in quarter 4 of 2021 but, because of the effect of Omicron, GDP would be flat in quarter 1, but with the economy recovering during February and March. Due to the hit to households' real incomes from higher inflation, it revised down its GDP growth forecast for 2022 from 3.75% to 3.25%.
- The Bank is concerned at how tight the labour market is with vacancies at near record levels and a general shortage of workers - who are in a very favourable position to increase earnings by changing job.
- As in the December 2021 MPC meeting, the MPC was more concerned with combating inflation over the medium term than supporting economic growth in the short term. However, what was notable was the Bank's forecast for inflation: based on the markets' expectations that Bank Rate will rise to 1.50% by mid-2023, it forecast inflation to be only 1.6% in three years' time. In addition, if energy prices beyond the next six months fell as the futures market suggests, the Bank said CPI inflation in three years' time would be even lower

at 1.25%. With calculations of inflation, the key point to keep in mind is that it is the rate of change in prices – not the level – that matters. Accordingly, even if oil and natural gas prices remain flat at their current elevated level, energy's contribution to headline inflation will drop back over the course of this year. That means the current energy contribution to CPI inflation, of 2% to 3%, will gradually fade over the next year.

- So the message to take away from the Bank's forecast is that they do not expect Bank Rate to rise to 1.5% in order to hit their target of CPI inflation of 2%. The immediate issue is with four members having voted for a 0.50% increase in February, it would only take one member more for there to be another 0.25% increase at the March meeting.
- **The MPC's forward guidance on its intended monetary policy** on raising Bank Rate versus selling (quantitative tightening) holdings of bonds is as follows:
 - Raising Bank Rate as "the active instrument in most circumstances".
 - Raising Bank Rate to 0.50% before starting on reducing its holdings.
 - Once Bank Rate is at 0.50% it would stop reinvesting maturing gilts.
 - Once Bank Rate had risen to at least 1%, it would start selling its holdings.

OUR FORECASTS

Bank Rate

- Covid remains a major potential downside threat as we are most likely to get further mutations. However, their severity and impact could vary widely, depending on vaccine effectiveness and how broadly it is administered.
- If the UK invokes article 16 of the Brexit deal over the dislocation in trading arrangements with Northern Ireland, this has the potential to end up in a no-deal Brexit.

In summary, with the high level of uncertainty prevailing on several different fronts, we expect to have to revise our forecasts again - in line with whatever the new news is.

PWLB rates and gilt and treasury yields

Gilt yields. Since the start of 2021, we have seen a lot of volatility in gilt yields, and hence PWLB rates. Our forecasts show little overall increase in gilt yields during the forecast period to March 2025 but there will doubtless be a lot of unpredictable volatility during this forecast period.

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

US treasury yields. During the first part of 2021, US President Biden's, and the Democratic party's, determination to push through a \$1.9trn (equivalent to 8.8% of GDP) fiscal boost for the US economy as a recovery package from the Covid pandemic was what unsettled financial markets. This was in addition to the \$900bn support package previously passed in December 2020. Financial markets were alarmed that all this stimulus was happening at a time when: -

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

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

- **At its 3rd November Fed meeting**, the Fed decided to make a start on tapering its \$120bn per month of QE purchases so that they ended next June. However, at its **15th December** meeting it doubled the pace of tapering so that they will end all purchases in February. These purchases are currently acting as downward pressure on treasury yields and so it would be expected that treasury yields will rise over the taper period, all other things being equal.
- It also forecast that it expected there would be three rate rises in 2022 of 0.25% from near zero currently, followed by three in 2023 and two in 2024. This would take rates back above 2% to a neutral level for monetary policy. It also gave up on calling the sharp rise in inflation as being 'transitory'.
- At its **26th January meeting**, the Fed became even more hawkish following inflation rising sharply even further. It indicated that rates would begin to rise very soon, i.e., it implied at its March meeting it would increase rates and start to run down its holdings of QE purchases. It also appears likely that the Fed could take action to force longer term treasury yields up by prioritising selling holdings of its longer bonds as yields at this end have been stubbornly low despite rising inflation risks. The low level of longer dated yields is a particular concern for the Fed because it is a key channel through which tighter monetary policy is meant to transmit to broader financial conditions, particularly in the US where long rates are a key driver of household and corporate borrowing costs.

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

Globally, our views are as follows: -

- **EU.** The ECB joined with the Fed by announcing on **16th December** that it will be reducing its QE purchases - by half from October 2022, i.e., it will still be providing significant stimulus via QE purchases during the first half of 2022. The ECB did not change its rate at its **3rd February** meeting, but it was clearly shocked by the increase in inflation to 5.1% in January. The President of the ECB, Christine Lagarde, hinted in the press conference after the meeting that the ECB may accelerate monetary tightening before long and she hinted that asset purchases could be reduced more quickly than implied by the previous guidance. She also refused to reaffirm officials' previous assessment that interest rate hikes in 2022 are "very unlikely". It, therefore, now looks likely that all three major western central banks will be raising rates this year in the face of sharp increases in inflation - which is looking increasingly likely to be stubbornly high and for much longer than the previous oft repeated 'transitory' descriptions implied.
- **CHINA.** The pace of economic growth has now fallen back after the initial surge of recovery from the pandemic and China has been struggling to contain the spread of the Delta variant through using sharp local lockdowns - which depress economic growth. However, with Omicron having now spread to China, and being much more easily transmissible, lockdown strategies may not prove so successful in future. To boost flagging economic growth, The People's Bank of China cut its key interest rate in December 2021.
- **JAPAN.** 2021 was a patchy year in combating Covid. However, recent business surveys indicate that the economy is rebounding rapidly now that the bulk of the population is fully vaccinated, and new virus cases have plunged. The Bank of Japan is continuing its very loose monetary policy but with little prospect of getting inflation back towards its target of 2% any time soon.
- **WORLD GROWTH.** World growth was in recession in 2020 but recovered during 2021 until starting to lose momentum more recently. Inflation has been rising due to increases in gas and electricity prices, shipping costs and supply shortages, although these should subside during 2022. It is likely that we are heading into a period where there will be a reversal of **world globalisation** and a decoupling of western countries from dependence on China to supply products, and vice versa. This is likely to reduce world growth rates from those in prior decades.
- **SUPPLY SHORTAGES.** The pandemic and extreme weather events, followed by a major surge in demand after lockdowns ended, have been highly disruptive of extended worldwide supply chains. Major queues of ships unable to unload their goods at ports in New York, California and China built up rapidly during quarters 2 and 3 of 2021 but then halved during quarter 4. Such issues have led to a misdistribution of shipping containers around the world and have contributed to a huge increase in the cost of shipping. Combined with a shortage of semi-conductors, these issues have had a disruptive impact on production in many countries. The latest additional disruption has been a shortage of coal in China leading to power cuts focused primarily on producers (rather than consumers), i.e., this will further aggravate

shortages in meeting demand for goods. Many western countries are also hitting up against a difficulty in filling job vacancies. It is expected that these issues will be gradually sorted out, but they are currently contributing to a spike upwards in inflation and shortages of materials and goods available to purchase.

The balance of risks to the UK economy: -

- The overall balance of risks to economic growth in the UK is now to the downside.

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

-

- **Mutations** of the virus render current vaccines ineffective, and tweaked vaccines to combat these mutations are delayed or unable to be administered fast enough to stop the NHS being overwhelmed.
- **Labour and supply shortages** prove more enduring and disruptive and depress economic activity.
- **Bank of England** acts too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- **The Government** acts too quickly to increase taxes and/or cut expenditure to balance the national budget.
- **UK / EU trade arrangements** – if there was a major impact on trade flows and financial services due to complications or lack of co-operation in sorting out significant remaining issues.
- **Geopolitical risks**, for example in Ukraine/Russia, Iran, China, North Korea and Middle Eastern countries, which could lead to increasing safe-haven flows. If Russia were to invade Ukraine, this would be likely to cause short term volatility in financial markets, but it would not be expected to have a significant impact beyond that.

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

- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary 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.
- Longer term US treasury yields rise strongly and pull gilt yields up higher than forecast.

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 and 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. It also manages interest rate risk by maintaining a number of discrete investment portfolios which are managed by external fund managers. The separation of equities, multi-asset and bond investments in this way effectively minimises the Council's exposure to interest rate movements.
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 Treasury Management 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 principle 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 Council carries an active exposure to market risk, e.g. those investing in investment instruments through the Strategic Reserve Fund 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 / 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 Treasury Management portfolio ensuring that no more than 25% of the total portfolio 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 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, in respect of the Strategic Reserve Fund managed fund investments, 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 Treasury Management deposits ensuring that no more than 25% of the total portfolio 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 18 months but usually 9 months or less), 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

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.

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.

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.

Private Debt Fund. This is an investment fund specialising in directly originated senior secured loans to private equity-owned businesses. Private debt provides a spread pick-up versus the syndicated loan markets. The privately negotiated debt deals tend to be structured with strong financial covenants which protect lenders. Lenders in the private credit market can also benefit from origination fees, which benefit banks in the syndicated market.

Strategic Alternative Income Fund. This is a collective investment fund specialising in private market assets. 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 potential for asset classes including infrastructure debt, renewable energy, real estate debt, long lease property and private credit. By their very nature, some of these asset classes are regarded as being higher risk and can be more illiquid, as such it is not considered prudent to hold individual stocks as a direct investment. This type of fund is designed to deliver predictable, long-term cash flows that have explicit and implicit linkage to inflation.

Table 1: permitted investments in house – Treasury Management and 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 (DMADF)	--	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 note 1	term	no	20%	2 years
Fixed term deposits with variable rate and variable maturities: - Structured deposits	See note 1	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	* MMF rating	instant	No See app 5.5	20%	60-day weighted average
2b. Money Market Funds LVNAV	* MMF rating	instant	No See app 5.5	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	* Bond fund rating (or alternative measure if not rated)	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 fund managers – Strategic Reserve Fund and Common Good

2.1 Deposits

	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Term deposits – local authorities	--	term	no	100%	2 years
Call accounts – banks and building societies **	See note 1	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 note 1	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	* MMF rating	instant	No see app 5.5	20%	60 days weighted average
2b. Money Market Funds LVNAV	* MMF rating	instant	No see app 5.5	20%	60 days weighted average
3. Ultra-short dated bond funds with a credit score of 1.25	* bond fund rating	T+>1	yes	20%	90 days weighted average
4. Ultra-short dated bond funds with a credit score of 1.5	* bond fund rating	T+>1	yes	20%	10 years weighted average
5. Bond Funds	* Bond fund rating (or alternative measure if not rated)	T+>1	yes	20%	10 years weighted average
6. Gilt Funds	* Bond fund rating (or alternative measure if not rated)	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	*Short-term F1, A1, P1, Long-term A	Sale T+1	yes	20%	1 year
Commercial paper other	* Short-term F1, A1, P1, Long-term A	Sale T+1	yes	20%	90 days
Corporate Bonds other	* Short-term F1, A1, P1, Long-term A	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 Funds	-	T+4	Yes	20%	30 years
Infrastructure Equity	-	T+4	Yes	20%	50 years
Illiquid or Private Debt Funds	-	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 asset fund 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, including Strategic Reserve Fund, 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) (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 they have a “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 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.
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.
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.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good Limits
<p>j. Corporate bonds (Medium to high risk depending on period & credit rating)</p>	<p>These are marketable securities issued by financial and corporate institutions. Counterparty risk will vary and there is risk to value of capital loss arising from selling ahead of maturity if combined with an adverse movement in interest rates. Liquidity risk will be low.</p>	<p>The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's. Corporate bonds will be restricted to those meeting the base criteria.</p> <p>Day to day investment dealing with these criteria will be further strengthened by the use of additional market intelligence.</p>	<p>20% and maximum 75 years.</p>	<p>20% and maximum 75 years.</p>

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.	£10M 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.	£25M 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, 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 Director 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 the 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

This list is based on those countries which have sovereign ratings of AA- or higher, (we show the lowest rating from Fitch, Moody's and S&P) and also, (except - at the time of writing - for Hong Kong, Norway and Luxembourg), have banks operating in sterling markets which have credit ratings of green or above in the Link credit worthiness service.

Based on lowest available rating

AAA

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

AA+

- Canada
- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)
- France

AA-

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

5.7 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 the 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 2022-2023
Service / service area responsible.	Enterprise and Sustainable Regeneration – Finance Services
Name of person carrying out the assessment and contact details.	Colin Kemp, Interim Head of Finance
Date of assessment.	17/02/22
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 2022-2023
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 ages.	No

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

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:

Date: 17/02/2022



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