East Lothian Council

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Additional information:

This document should be read on conjunction with the report to Council on 27 February 2018 - Treasury Management Strategy 2018/19 to 2020/21

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Designation	Head of Council Resources
Date	15/02/18

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Treasury Management Strategy Statement

2018 - 2021

1 INTRODUCTION

1.1 Background

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

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

CIPFA defines treasury management as:

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

1.2 Reporting requirements

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

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

- the capital plans (including prudential indicators);
- the treasury management strategy (how the investments and borrowings are to be organised) including treasury indicators; and
- an investment strategy (the parameters on how investments are to be managed).

A mid year treasury management report – This will update members with the progress of the capital position, amending prudential indicators as necessary, and whether any policies require revision

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

Scrutiny

Scrutiny will be provided by the Audit & Governance Committee.

Capital Strategy
In December 2017, CIPFA issued revised Prudential and Treasury Management Codes. As from 2019-20, all local authorities will be required to prepare an additional report, a Capital Strategy report, which is intended to provide the following: -

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

The aim of this report is to ensure that all elected members on the full council fully understand the overall strategy, governance procedures and risk appetite entailed by this Strategy.

The Capital Strategy will include capital expenditure, investments and liabilities and treasury management in sufficient detail to allow all members to understand how stewardship, value for money, prudence, sustainability and affordability will be secured.

1.3 Treasury Management Strategy for 2018/19

The strategy for 2018/19 covers two main areas:

Capital issues

- the capital plans and the prudential indicators..

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
- 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 Investment Regulations.

1.4 Training

The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsibe for scrutiny.Training for members is being arranged for 2018/19.

The training needs of treasury management officers are periodically reviewed.

1.5 Treasury management consultants

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

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

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

2 THE CAPITAL PRUDENTIAL INDICATORS 2018/19 – 2020/21

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

2.1 Capital expenditure

This prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle. Members are asked to approve the capital expenditure forecasts:

Capital expenditure £'000	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
General Services	**18,559**	**32,152**	**44,974**	**46,097**	**52,639**
HRA	**23,343**	**23,421**	**24,364**	**37,683**	**33,754**
Total	**41,902**	**55,573**	**69,338**	**83,780**	**86,393**

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

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

Capital expenditure £'000	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
Total Cap Ex	41,902	55,573	69,338	83,780	86,393
Financed by:					
Capital receipts	9,426	15,529	12,698	25,270	21,624
Capital Grants	13,472	15,545	15,464	18,947	19,870
Capital reserves	141				
Revenue	3200	2,500	1,700	2,600	3,500
Net financing need for the year	**15,663**	**21,999**	**39,476**	**36,963**	**41,399**

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

The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. Any capital expenditure above, which has not immediately been paid for, 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. East Lothian Council uses scheduled debt amortisation, (loans pool charges), 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 and so the Council is not required to separately borrow for these schemes. The Council currently has £41m of such schemes within the CFR.

The Council is asked to approve the CFR projections below:

£'000	**2016/17 Actual**	**2017/18 Estimate**	**2018/19 Estimate**	**2019/20 Estimate**	**2020/21 Estimate**
Capital Financing Requirement					
CFR – General Services	217,559	212,810	221,399	217,495	221,574
PFI & Leasing	41,318	39,723	38,245	36,898	35,353
CFR – housing	169,092	181,171	196,403	220,541	239,906
Total Gross CFR	**427,969**	**433,704**	**456,047**	**474,934**	**496,833**
Movement in CFR	**405**	**5,735**	**22,343**	**18,887**	**21,899**

Movement in CFR represented by					
Net financing need for the year (above)	15,663	21,999	39,476	36,963	41,399
Less scheduled debt amortisation	15,258	16,264	17,133	18,076	19,500
Movement in CFR	**405**	**5,735**	**22,343**	**18,887**	**21,899**

3 BORROWING

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

3.1 Current portfolio position

The Council's treasury portfolio position at 31 March 2017, with forward projections are summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

£'000	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
External Debt					
Debt at 1 April	337,160	344,247	358,084	380,248	399,707
Expected change in Debt	7,087	13,837	22,164	19,459	24,121
Other long-term liabilities (OLTL)	42,506	41,318	39,723	38,245	36,898
Expected change in OLTL	-1,188	-1,595	-1,478	-1,347	-1,545
Actual gross debt at 31 March	**385,565**	**397,807**	**418,493**	**436,605**	**459,181**
The Capital Financing Requirement	**427,970**	**433,704**	**456,047**	**474,934**	**496,833**
Under / (over) borrowing	**42,405**	**35,897**	**37,554**	**38,329**	**37,652**

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

The Head of Council Resources 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.

Operational boundary £'000	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
Debt	393,980	417,801	438,035	461,479
Other long term liabilities	39,723	38,245	36,898	35,353
Total	433,703	456,046	474,933	496,832

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

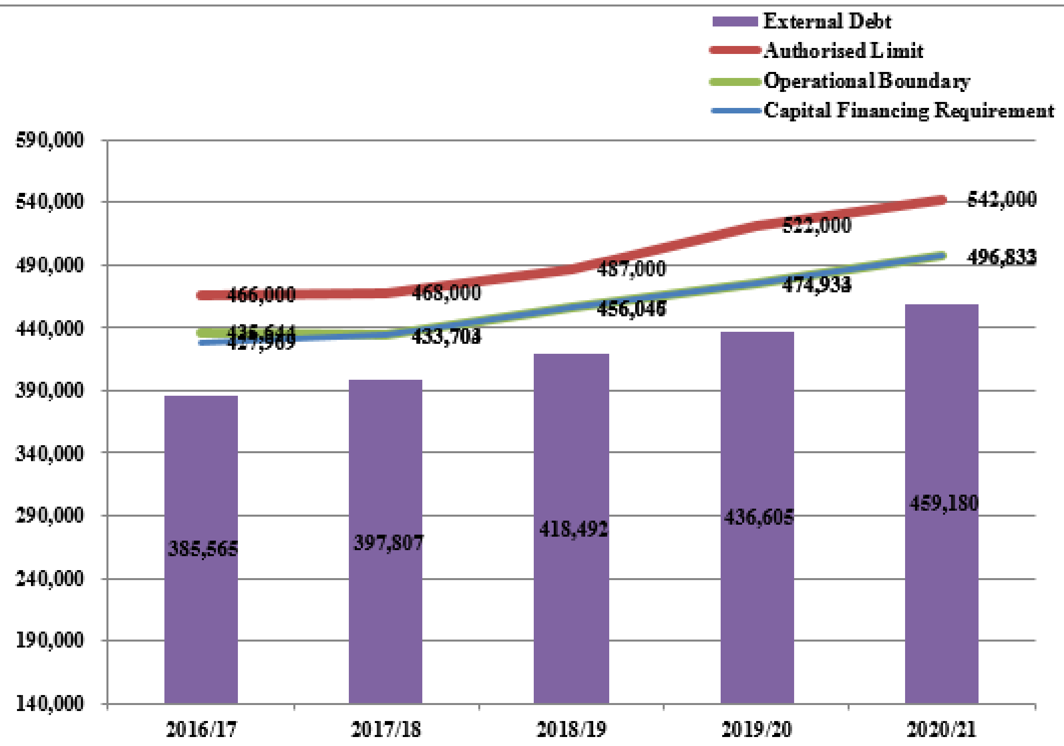
a) This is the statutory limit (Affordable Capital Expenditure Limit) determined under section 35 (1) of the Local Government in Scotland Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised.

b) The Council is asked to approve the following authorised limits:

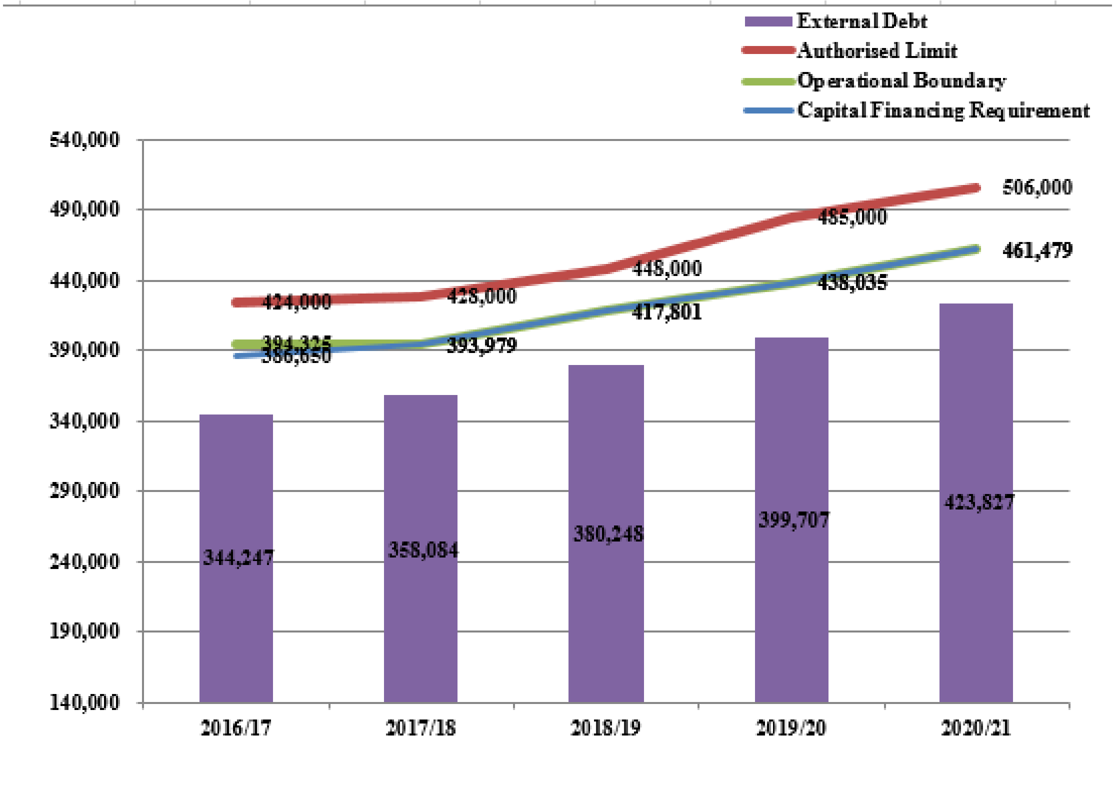
Authorised limit £'000	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
Debt	428,000	448,000	485,000	506,000
Other long term liabilities	40,000	39,000	37,000	36,000
Total	**468,000**	**487,000**	**522,000**	**542,000**

Capital Financing Requirements

Including PFI & Leasing	2016/17	2017/18	2018/19	2019/20	2020/21
	£'000	£'000	£'000	£'000	£'000
Authorised Limit	466,000	468,000	487,000	522,000	542,000
Operational Boundary	435,644	433,703	456,046	474,933	496,832
Capital Financing Requirement	427,969	433,704	456,047	474,934	496,833
External Debt	385,565	397,807	418,492	436,605	459,180



Excluding PFI & Leases	2016/17	2017/18	2018/19	2019/20	2020/21
	£'000	£'000	£'000	£'000	£'000
Authorised Limit	424,000	428,000	448,000	485,000	506,000
Operational Boundary	394,325	393,979	417,801	438,035	461,479
Capital Financing Requirement	386,650	393,979	417,801	438,035	461,479
External Debt	344,247	358,084	380,248	399,707	423,827



3.3 Prospects for interest rates

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

	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate	0.50%	0.75%	0.75%	1.00%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.50%
5 yr PWLB	1.90%	2.00%	2.10%	2.10%	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%
10 yr PWLB	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%
25 yr PWLB	2.80%	2.90%	3.00%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%	3.40%	3.50%	3.60%	3.60%
50 yr PWLB	2.60%	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%	3.40%

As expected, the Monetary Policy Committee (MPC) delivered a 0.25% increase in Bank Rate at its meeting on 2 November. This removed the emergency cut in August 2016 after the EU referendum. The MPC also gave forward guidance at this time that they expected to increase Bank rate only twice more by 0.25% by 2020 to end at 1.00%. However, the MPC, and Carney in their latest press conference, emphasised that MPC decisions will be driven by **how data actually turns out during the year.** We are therefore in a delicate situation where we need to recognise the stronger words from the Bank warning on an "earlier and greater than anticipated" rate of increase in Bank Rate; financial markets duly increased their risk assessment of a Bank Rate increase in May from 50% to 75% after the MPC meeting on 2nd of February.

The Link Asset Services forecast as above includes increases in Bank Rate of 0.25% in May 2018, November 2018, November 2019 and August 2020.

The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. It has long been expected, that at some point, there would be a more protracted move from bonds to equities after a historic long-term trend, over about the last 25 years, of falling bond yields. The action of central banks since the financial crash of 2008, in implementing substantial Quantitative Easing, added further impetus to this downward trend in bond yields and rising bond prices. Quantitative Easing has also directly led to a rise in equity values as investors searched for higher returns and took on riskier assets. The sharp rise in bond yields since the US Presidential election in November 2016 has called into question whether the previous trend may go into reverse, especially now the Fed. has taken the lead in reversing monetary policy by starting, in October 2017, a policy of not fully reinvesting proceeds from bonds that it holds when they mature.

Until 2015, monetary policy was focused on providing stimulus to economic growth but has since started to refocus on countering the threat of rising inflationary pressures as stronger economic growth becomes more firmly established. The Fed. has started raising interest rates and this trend is expected to continue during 2018 and 2019. These increases will make holding US bonds much less attractive and cause their prices to fall, and therefore bond yields to rise. Rising bond yields in the US are likely to exert some upward pressure on bond yields in the UK and other developed economies. However, the degree of that upward pressure is likely to be dampened by how strong or weak the prospects for economic growth and rising inflation are in each country, and on the degree of progress towards the reversal of monetary policy away from quantitative easing and other credit stimulus measures.

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

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

The overall balance of risks to economic recovery in the UK is probably to the downside, particularly with the current level of uncertainty over the final terms of Brexit.

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

- The Bank of England takes action too quickly 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.
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.
- A resurgence of the Eurozone sovereign debt crisis, possibly Italy, due to its high level of government debt, low rate of economic growth and vulnerable banking system.
- Weak capitalisation of some European banks.
- Germany is still without an effective government after the inconclusive result of the general election in October. In addition, Italy is to hold a general election on 4 March and the anti EU populist Five Star party is currently in the lead in the polls, although it is unlikely to get a working majority on its own. Both situations could pose major challenges to the overall leadership and direction of the EU as a whole and of the individual respective countries. Hungary will hold a general election in April 2018.
- The result of the October 2017 Austrian general election has now resulted in a strongly anti-immigrant coalition government. In addition, the Czech ANO party became the largest party in the October 2017 general election on a platform of being strongly against EU migrant quotas and refugee policies. Both developments could provide major impetus to other, particularly former Communist bloc countries, to coalesce to create a major block to progress on EU integration and centralisation of EU policy. This, in turn, could spill over into impacting the Euro, EU financial policy and financial markets.
- Rising protectionism under President Trump
- A sharp Chinese downturn and its impact on emerging market countries

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

- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- UK inflation returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.
- The Fed causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and

strength of reversal of Quantitative Easing, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.

Investment and borrowing rates

- Investment returns are likely to remain low during 2018/19 but to be on a gently rising trend over the next few years.
- Borrowing interest rates increased sharply after the result of the general election in June and then after the September MPC meeting when financial markets reacted by accelerating their expectations for the timing of Bank Rate increases. Apart from that, there has been little general trend in rates during the current financial year. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in the future when authorities may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt;
- There will remain a cost of carry to any new long-term borrowing that causes a temporary increase in cash balances, as this position will, most likely, incur a revenue cost – the difference between borrowing costs and investment returns.

3.4 Borrowing strategy

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

Against this background and the risks within the economic forecast, caution will be adopted with the 2018/19 treasury operations. The Head of Corporate Resources will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

- if it was felt that there was a significant risk of a sharp FALL in long and short term rates (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.
- if it was felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast, perhaps arising from an acceleration in the start date and 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 through the mid-year or annual activity reports.

3.5 Policy on borrowing in advance of need

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

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

3.6 Debt rescheduling

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

The reasons for any rescheduling to take place will include:

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

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

All rescheduling will be reported through the mid-year or annual activity reports.

4 ANNUAL INVESTMENT STRATEGY

4.1 Investment policy

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

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

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

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

Investment instruments identified for use in the financial year are listed in appendices 5.3 and 5.4. Counterparty limits will be as set through the Council's treasury management practices – schedules.

4.2 Creditworthiness policy

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

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

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

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

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

Typically the minimum credit ratings criteria the Council use will be a Short Term rating (Fitch or equivalents) of F1 and a Long Term rating of A-. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

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

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

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

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

	Colour (and long term rating where applicable)	Money and/or % Limit	Time Limit
Banks *	yellow	£5m	5yrs
Banks	purple	£5m	2 yrs
Banks	orange	£5m	1 yr
Banks – part nationalised	blue	£5m	1 yr
Banks	red	£5m	6 mths
Banks	green	£5m	100 days
Banks	No colour	Not to be used	
Limit 3 category – Council's banker (not meeting Banks 1)	Lloyds Bank	Unlimited	1 day #
DMADF	UK Sovereign Rating	unlimited	6 months
Local authorities	n/a	£5m	3yrs
	Fund rating	**Money and/or % Limit**	**Time Limit**
Money Market Funds CNAV	AAA	£5m	liquid
Money Market Funds LVNAV	AAA	£5m	liquid
Money Market Funds VNAV	AAA	£5m	liquid
Ultra short dated bond funds with a credit score of 1.25	Dark pink / AAA	£5m	liquid
Ultra short dated bond funds with a credit score of 1.5	Light pink / AAA	£5m	liquid

Balances held over night with the Councils Bank are reviewed on a daily basis

4.3 Country and sector limits

The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of *AA* from Fitch (or equivalent). The list of countries that qualify using this credit criteria as at the date of this report are shown in Appendix 5.5. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

4.4 Investment strategy

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

Investment returns expectations.
Bank Rate is forecast to stay flat at 0.50% until quarter 4 2018 and not to rise above 1.25% by quarter 1 2021. Bank Rate forecasts for financial year ends (March) are:

- 2017/18 0.50%
- 2018/19 0.75%
- 2019/20 1.00%
- 2020/21 1.25%

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

	Now
2017/18	0.40%
2018/19	0.60%
2019/20	0.90%
2020/21	1.25%
2021/22	1.50%
2022/23	1.75%
2023/24	2.00%
Later years	2.75%

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

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

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

Maximum principal sums invested > 364 & 365 days			
£m	**2018/19**	**2019/20**	**2020/21**
Principal sums invested > 364 & 365 days	£m 10	£m 10	£m 10

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

4.5 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.

4.6 Common Good & Charitable Trusts Investments

East Lothian Common Good funds and Charitable Trust funds are managed in two separate portfolios by an external investment management company, Investec. At 31st December 2017, the East Lothian Charitable Trust portfolio was valued at £3.485m while the Common Good portfolio was valued at £3.566m. The Council has set the objective for these funds to achieve growth in income and capital over the long term**.**

Both of the investment portfolios are classified as medium/high risk and are structured as follows:

- **Quality**: the aim is to hold at least 25% of the UK equity content in a combination of individual stocks within the FTSE100 Index and of ‘generalist’ collective funds
- **Concentration**: no individual stock should account for more than 10% of the equity content of the portfolio. No individual bond should account for more than 10% of the total portfolio.
- **Diversification**: any holdings valued at over 5% of the portfolio may not, in aggregate, represent more than 40% of the portfolio. There is no restriction on the percentage of the overseas equity content in generalist collective funds. Portfolios of a value of less than £100,000 should be substantially invested in collective funds.

Reporting

- Investec produce performance reports on a quarterly basis comparing performance to set investment benchmarks. These reports are reviewed by the Head of Council Resources.

- A summary report will be submitted to the full Council at least once a year on the performance of the portfolio.

- Ad hoc reports will be submitted to the Council should any significant events occur which in the opinion of the Head of Council Resources might affect the performance of the portfolio or the security of the investments.

- Reports will be submitted to individual Common Good committees or Trust boards as requested.

5 APPENDICES

1. Prudential and treasury indicators
2. Brexit
3. Treasury management practice 1 – credit and counterparty risk management
4. Treasury management practice 1 – credit and counterparty risk management (summary)
5. Approved countries for investments
6. Treasury management scheme of delegation
7. The treasury management role of the section 95 officer

5.1 THE CAPITAL PRUDENTIAL AND TREASURY INDICATORS 2018/19 – 2020/21

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

5.1.1 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.

Scottish Government guidance provides 4 options to Councils so long as a prudent provision is made each year. The Council is recommended to approve the following policy on the repayment of loans fund advances:-

For loans fund advances made before 1 April 2016, the policy will be to maintain the practice of previous years and apply the **Statutory Method (option 1)**, with all loans fund advances being repaid by the annuity method

For loans fund advances made after 1 April 2016, the policy for the repayment of loans advances will be the **Statutory Method (option 1)**

1. **Statutory method** – loans fund advances will be repaid by the annuity method (option 1).
   The Council is permitted to use this option for a transitional period only, of five years until 31st March 2021, at which time it must change its policy to use alternative approaches based on depreciation, asset life periods or a funding/income profile;

The other options are

2. **Depreciation method** – annual repayment of loans fund advances will follow standard depreciation accounting procedures (option 2);

3 **Asset life method** – loans fund advances will be repaid with reference to the life of an asset using the annuity method (option 3);

4. **Funding / Income profile method** – loans fund advances will be repaid by reference to an associated income stream (option 4).

The annuity rate applied to the loans fund repayments was based on historic interest rates and is currently 4%. However, under regulation 14 (2) of SSI 2016 No 123, the

Council has reviewed and re-assessed the historic annuity rate to ensure that it is a prudent application. The result of this review suggests that an annuity rate of 4% provides a fair and prudent approach and provides principal repayments closely associated with the use of the assets.

The General Services loans fund balances, assuming no further advances beyond year 5, are expected to be:

General Services £'000

Years	Opening balance	Advances	Repayments	Closing Balance
1	212,809	20,847	12,258	221,398
2-5	221,398	58,965	55,536	224,827
5-10	224,827		73,240	151,587
10-15	151,587		52,450	99,137
15-20	99,137		37,119	62,018
21-30	62,018		50,872	11,146
31-40	11,146		11,146	0
41-50	0		0	0

The HRA loans fund balances, assuming no further advances beyond year 5, are expected to be:

HRA £'000

Years	Opening balance	Advances	Repayments	Closing Balance
1	181,171	18,628	3,398	196,403
2-5	196,403	101,445	19,408	278,440
5-10	278,440		35,267	243,173
10-15	243,173		42,562	200,611
15-20	200,611		47,349	153,262
21-30	153,262		109,886	43,376
31-40	43,376		38,369	5,007
41-50	5,007		5,007	0

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.

£'000	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
GS Revenue Stream	217,047	223,131	224,635	226,196	229,084
HRA Revenue Stream	26,956	28,673	29,760	32,066	34,781
GS Financing Costs	18,505	18,998	19,711	20,257	20,752
HRA Financing Costs	9,104	9,124	10,045	11,044	12,389
General Services	8.53%	8.51%	8.77%	8.96%	9.06%
HRA	33.77%	31.82%	33.75%	34.44%	35.62%

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

b. General Services ratios

£	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
General Services Debt £'000	**217,559**	**212,809**	**221,399**	**217,495**	**221,574**
Band D Equivalents	**43,877**	**47,369**	**48,253**	**49,142**	**50,030**
Debt per Band D Equivalent £	**4,958**	**4,493**	**4,588**	**4,425**	**4,429**

c. HRA ratios

£	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
HRA debt £'000	**169,092**	**181,171**	**196,403**	**220,541**	**239,906**
Number of HRA dwellings £m	**8649**	**8693**	**8735**	**8920**	**9090**
Debt per dwelling £	**19,550**	**20,841**	**22,485**	**24,724**	**26,392**

5.1.3 Treasury indicators for debt

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

- Upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates based upon the debt position net of investments
- Upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates;
- 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:

£m	**2018/19**	**2019/20**	**2020/21**
Interest rate exposures			
	Upper	**Upper**	**Upper**
Limits on fixed interest rates based on net debt	100%	100%	100%
Limits on variable interest rates based on net debt	40%	40%	40%
Maturity structure of fixed interest rate borrowing 2018/19			
		Lower	**Upper**
Under 12 months		0%	20%
12 months to 2 years		0%	30%
2 years to 5 years		0%	40%
5 years to 10 years		0%	40%
10 years to 20 years		0%	75%
20 years to 30 years		0%	75%
30 years to 40 years		0%	75%
40 years to 50 years		0%	75%
Maturity structure of variable interest rate borrowing 2018/19			
		Lower	Upper
Under 12 months		0%	100%
12 months to 2 years		0%	50%
2 years to 5 years		0%	30%
5 years to 10 years		0%	20%
10 years to 20 years		0%	20%
20 years to 30 years		0%	20%
30 years to 40 years		0%	20%
40 years to 50 years		0%	20%

5.2 BREXIT TIMETABLE AND PROCESS

- March 2017: UK government notifies the European Council of its intention to leave under the Treaty on European Union Article 50
- March 2019: initial two-year negotiation period on the terms of exit. In her Florence speech in September 2017, the Prime Minister proposed a two-year transitional period after March 2019.
- UK continues as a full EU member until March 2019 with access to the single market and tariff free trade between the EU and UK. Different sectors of the UK economy will leave the single market and tariff free trade at different times during the two-year transitional period.
- The UK and EU would attempt to negotiate, among other agreements, a bi-lateral trade agreement over that period.
- The UK would aim for a negotiated agreed withdrawal from the EU, although the UK could also exit without any such agreements in the event of a breakdown of negotiations.
- If the UK exits without an agreed deal with the EU, World Trade Organisation rules and tariffs could apply to trade between the UK and EU - but this is not certain.
- On full exit from the EU: the UK parliament would repeal the 1972 European Communities Act.
- The UK will then no longer participate in matters reserved for EU members, such as changes to the EU's budget, voting allocations and policies.

5.3 TREASURY MANAGEMENT PRACTICE (TMP1): PERMITTED INVESTMENTS

This Council approves the following forms of investment instrument for use as permitted investments as set out in the following tables

Cash type instruments

- Deposits with the Debt Management Account Facility (UK Government);
- Deposits with other local authorities or public bodies;
- Money Market Funds – CNAV,LVNAV & VNAV
- Call account deposit accounts with financial institutions (banks and building societies);
- Term deposits with financial institutions (banks and building societies);
- UK Government Gilts and Treasury Bills;
- Supranational Bonds (e.g. World Bank)
- Certificates of deposits with financial institutions (banks and building societies)
- Structured deposit facilities with banks and building societies (escalating rates, de-escalating rates etc.);
- Corporate bonds;
- Bond funds;
- Ultra short dated bond funds
- Gilt funds
- Property funds;

Other investments

- Investment properties;
- Loans to third parties, including soft loans and loans made for service policy reasons
- Loans to a local authority company including loans made for service policy reasons
- Shareholdings in a local authority company;
- Non-local authority shareholdings.
- House Purchase Loans – Under Tenant Rights, etc (Scotland) Act 1980 & section 214 of the Housing (Scotland) Act 1987

Treasury risks

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

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

2. **Liquidity risk:** this is the risk that cash will not be available when it is needed. While it could be said that all counterparties are subject to at least a very small level of liquidity risk as credit risk can never be zero, in this document, liquidity risk has been treated as whether or not instant access to cash can be obtained from each form of investment instrument. However, it has to be pointed out that while some forms of investment e.g. gilts, CDs, corporate bonds can usually be sold immediately if the need arises, there are two caveats: - a. cash may not be available until a settlement date up to three days after the sale b. There is an implied assumption that markets will not freeze up and so the instrument in question will find a ready buyer. The column in tables 1 / 2 headed as 'market risk' will show each investment instrument as being instant access, sale T+3 = transaction date plus 3 business days before you get cash, or term i.e. money is locked in until an agreed maturity date.

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

4. **Interest rate risk**: this is the risk that fluctuations in the levels of interest rates create an unexpected or unbudgeted burden on the organisation's finances, against which the organisation has failed to protect itself adequately. This authority has set limits for its fixed and variable rate exposure in its Treasury Indicators in this report. All types of investment instrument have interest rate risk except for the following forms of instrument which are at variable rate of interest (and the linkage for variations is also shown): - (Link Asset Services note – please specify any such instruments should you use them)

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

Controls on treasury risks

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

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

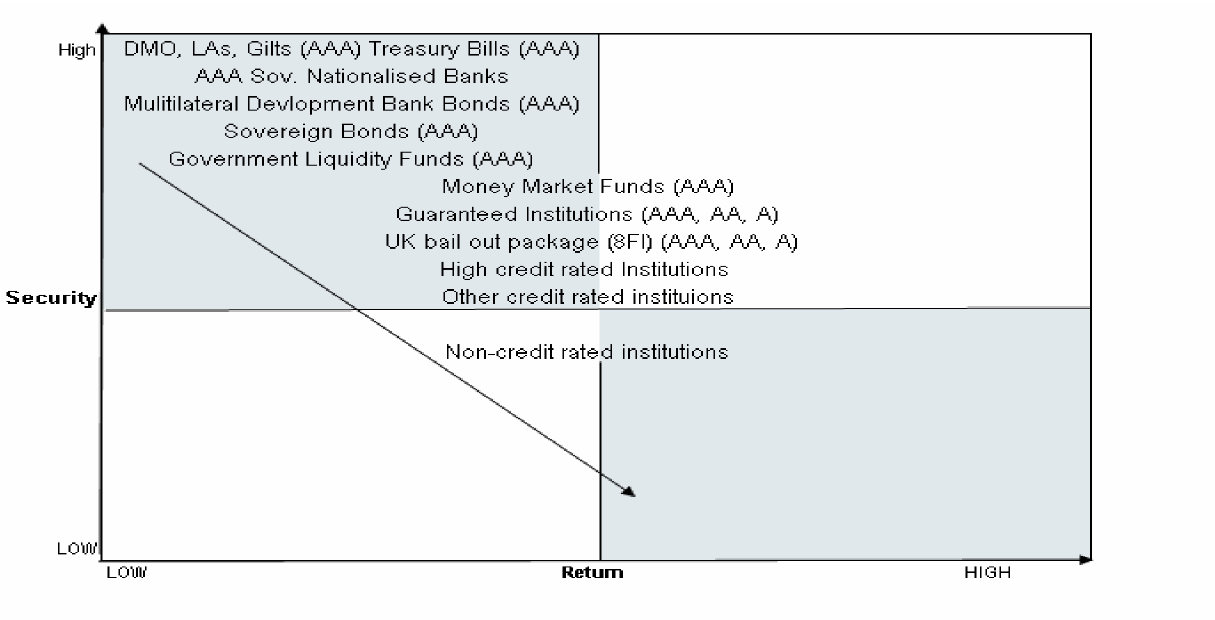
3. **Market risk:** this authority purchases/invests in, money market funds, Gilts, treasury bills, CDs, bonds etc.as they offer a higher rate of return than depositing in the DMADF. They are usually held until maturity but in exceptional circumstances, they can be quickly sold at the current market value, (which may vary from the purchase cost), if the need arises for extra cash at short notice. Their value does not usually vary much during their short life.

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 complied with all regulations. All types of investment instruments

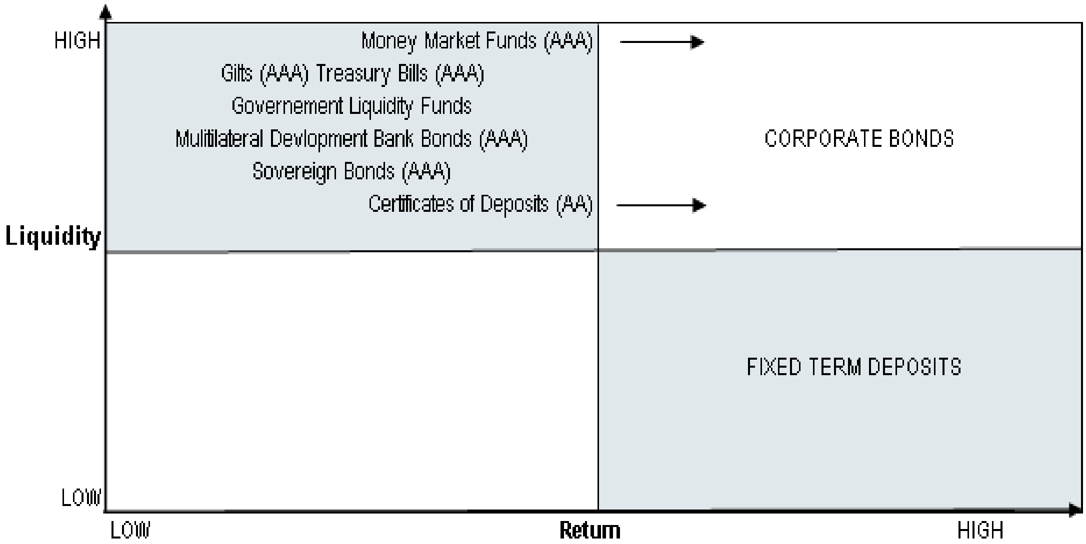
The graph below summarises the risk exposure of various types of investment instrument. It shows that as you move from top to bottom, so the level of credit risk increases. However, moving from top to bottom also results in moving towards the right i.e. returns increase. The overall message is -

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



The next graph shows the other message: -

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



Unlimited investments

Regulation 24 states that an investment can be shown in table 1 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 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.

High credit worthiness banks and building societies. See paragraph 4.2 for an explanation of this authority's definition of high credit worthiness. While an unlimited amount of the investment portfolio may be put into banks and building societies with high credit worthiness, the authority will ensure diversification of its portfolio ensuring that no more than £5m can be placed with any one institution or group at any one time. The Council's own banker (Lloyds Banking Group) may have sums greater than this held overnight.

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’

DEPOSITS

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

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

b) **Term deposits with high credit worthiness banks and building societies.** See paragraph 4.2 for an explanation of this authority’s definition of high credit worthiness. This is the most widely used form of investing used by local authorities. It offers a much higher rate of return than the DMADF (dependent on term). The authority will ensure diversification of its portfolio of deposits ensuring that no more than £5m 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. 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)

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. These tend to be medium to low risk investments, but will exhibit higher risks than categories a) 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).

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. These 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..

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

c. **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.

d. **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.

e. **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.

f. **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. 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.

a. **Investment Properties.** These are non-service properties which are being held pending disposal or for a longer term rental income stream.

b. **Loans to third parties, including soft loans**. These are service investments either at market rates of interest or below market rates (soft loans).

c. **Loans to a local authority company.** These are service investments either at market rates of interest or below market rates (soft loans).

d. Shareholdings in a local authority company. These are service investments.

e. Non-local authority shareholdings. These are non-service investments.

f. **House Purchase Loans.** These are loans that were made with regard to Tenant Rights, etc (Scotland) Act 1980 & section 214 of the Housing (Scotland) Act 1987

Counterparty criteria

Surplus money in the Council's Loans Fund may only be advanced to another UK local authority, government guaranteed institution and third parties and local authority companies as included within the permitted investments. In addition to:

1. Any bank or financial institution which meets the following criteria:-

(i) It falls into one of the groups of banks or financial institutions and appears in our treasury advisors LAS) credit rating matrix as approved, specifically a short term rating F-1 (or better) and a long term rating of A- from Fitch (or equivalent)

(ii) The Council's own bankers.

2. Any money market fund that meets the following criteria:-

(i) It is a Sterling denominated fund domiciled within the EU as regulated by the Institutional Money Market Funds Association (IMMFA)

(ii) It falls into one of the groups of banks, financial institutions or insurance companies and the institution concerned has a rating of AA- from Moody's or a rating of AAAmmf from Fitch or a rating of AAAm with Standard & Poor.

A list of approved counterparties will be maintained by the S95 officer and reviewed in line with the LAS counterparty rating service

Table 1: permitted investments in house

1.1 Deposits

	*** Minimum Credit Criteria / colour banding**	**Liquidity risk**	**Market risk**	**Max % of total investments**	**Max. maturity period**
Debt Management Agency Deposit Facility	--	term	no	**100%**	**6 mths**
Term deposits – local authorities	--	term	no	**100%**	**3 Years**
Call accounts – banks and building societies **	As counterparty criteria above	instant	no	**100%**	n/a
Term deposits – banks and building societies **	as counterparty criteria above	term	no	**100%**	5 years
Fixed term deposits with variable rate and variable maturities: - Structured deposits.	as counterparty criteria above	term	no	20%	12 mths

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	as counterparty criteria above	term	no	**100%**	**12 mths**
Banks part nationalised by high credit rated (sovereign rating) countries – non UK	as counterparty criteria above	term	no	**20%**	**3 mths**
Fixed term deposits with variable rate and variable maturities: - Structured deposits	as counterparty criteria above	term	yes	20%	**3 mths**

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

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%**	**5 yrs**
UK Government Gilts	UK sovereign rating	Sale T+1	yes	**20%**	**5 yrs**
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%**	**5 yrs**
Sovereign bond issues (other than the UK govt)	AAA (or state your criteria if different)	Sale T+1	yes	**20%**	**5 yrs**
Bonds issued by multilateral development banks	AAA (or state your criteria if different)	Sale T+1	yes	**20%**	**5 yrs**

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	As counterparty criteria above	Sale T+0	yes	**20%**	**5 yrs**
Corporate Bonds other	As counterparty criteria above	Sale T+3	yes	20%	5 yrs

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	As counterparty criteria above	T+4	yes	20%	5 yrs

5.4 TREASURY MANAGEMENT PRACTICE (TMP1): CREDIT AND COUNTERPARTY RISK MANAGEMENT (Summary)

East Lothian Council Permitted Investments, Associated Controls and Limits

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits
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.	£unlimited, 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.	£unlimited and maximum 3 years.
c. Money Market Funds (MMFs) **(Low to very low risk)** *CNAV / LVNAV / VNAV*	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.	£5m per fund

Type of Investment	Treasury Risks	Mitigating Controls	Council 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.	£5m per fund
e. Call account deposit accounts with financial institutions (banks and building societies) **(Low risk depending on credit rating)**	These tend to be low risk investments, but will exhibit higher risks than categories (a), (b) and (c) above. Whilst there is no risk to value with these types of investments, liquidity is high and investments can be returned at short notice.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody’s and Standard and Poor’s Day to day investment dealing with this criteria will be further strengthened by use of additional market intelligence.	As shown in the counterparty section criteria above.
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 this criteria will be further strengthened by use of additional market intelligence.	As shown in the counterparty section criteria above.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits
g. Government Gilts and Treasury Bills **(Very low risk)**	These are marketable securities issued by the UK Government and as such counterparty and liquidity risk is very low, although there is potential risk to value arising from an adverse movement in interest rates (no loss if these are held to maturity.	Little counterparty mitigating controls are required, as this is a UK Government investment. The potential for capital loss will be reduced by limiting the maximum monetary and time exposures.	As shown in the counterparty section criteria above.
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 this criteria will be further strengthened by the use of additional market intelligence.	As shown in the counterparty Section criteria above

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits
i. Structured deposit facilities with banks and building societies (escalating rates, de-escalating rates etc.) **(Low to medium risk depending on period & credit rating)**	These tend to be medium to low risk investments, but will exhibit higher risks than categories (a), (b) and (c) above. Whilst there is no risk to value with these types of investments, liquidity is very low and investments can only be broken with the agreement of the counterparty (penalties may apply).	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's. Day to day investment dealing with this criteria will be further strengthened by the use of additional market intelligence.	As shown in the counterparty section criteria above.
j. Corporate bonds **(Medium to high risk depending on period & credit rating)**	These are marketable securities issued by financial and corporate institutions. Counterparty risk will vary and there is risk to value of capital loss arising from selling ahead of maturity if combined with an adverse movement in interest rates. Liquidity risk will be low.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's. . Corporate bonds will be restricted to those meeting the base criteria. Day to day investment dealing with this criteria will be further strengthened by the use of additional market intelligence.	As shown in the counterparty section criteria above

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits
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.	as counterparty criteria above
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.	as counterparty criteria above
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.	as counterparty criteria above
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.	as counterparty criteria above

Type of Investment	Treasury Risks	Mitigating Controls	Council 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.	£as counterparty criteria above
f. House Purchase Loans	These are service investments which exhibit counterparty risk and are highly illiquid	Each loan to a council tenant requires Member approval and each application is supported by the service rational behind the loan and the likelihood of partial or full default.	£as counterparty criteria above

The Monitoring of Investment Counterparties - The status of counterparties will be monitored regularly. The Council receives credit rating and market information from Link Asset Services, including when ratings change, and counterparties are checked promptly. On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the 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 current policy to use external fund managers for the Common Good Funds and Charitable Trust funds. The investment policy for these funds is outlined in paragraph 4.7 of this strategy.

5.5 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 Asset Services credit worthiness service.

AAA

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

AA+

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

AA

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

AA-

- Belgium
- Qatar

This page is correct as at 15.1.18

5.6 TREASURY MANAGEMENT SCHEME OF DELEGATION

The following reporting arrangements will apply to Treasury Management activity:

(i) Full council

;

- approval of annual strategy.

(ii) Audit & Governance Committee

- Annual Treasury report

iii) Members Library

- Reports on Treasury Management activity including a mid-year review at the end of quarter 2.

(iv) Body/person(s) with responsibility for scrutiny

- The Council has delegated authority to the Head of Council Resources to effect movement between borrowing and long-term liabilities within the total authorised limits and operational boundaries approved. Any such movement would be reported to Cabinet via the Members Library as part of Treasury Management update reports.

5.7 THE TREASURY MANAGEMENT ROLE OF THE SECTION 95 OFFICER

The S95 (responsible) officer – Head of Council Resources

- 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.
- ensuring that the capital strategy is prudent, sustainable, affordable and prudent in the long term and provides value for money
- ensuring that due diligence has been carried out on all treasury and non-financial investments and is in accordance with the risk appetite of the authority
- ensure that the authority has appropriate legal powers to undertake expenditure on non-financial assets and their financing
- ensuring the proportionality of all investments so that the authority does not undertake a level of investing which exposes the authority to an excessive level of risk compared to its financial resources
- ensuring that an adequate governance process is in place for the approval, monitoring and ongoing risk management of all non-financial investments and long term liabilities
- ensuring that members are adequately informed and understand the risk exposures taken on by an authority
- ensuring that the authority has adequate expertise, either in house or externally provided, to carry out the above
- creation of Treasury Management Practices which specifically deal with how non treasury investments will be carried out and managed, to include the following

    - *Risk management (TMP1 and schedules), including investment and risk management criteria for any material non-treasury investment portfolios;*

    - *Performance measurement and management (TMP2 and schedules), including methodology and criteria for assessing the performance and success of non-treasury investments;*

    - *Decision making, governance and organisation (TMP5 and schedules), including a statement of the governance requirements for decision making in relation to non-treasury investments; and arrangements to ensure that appropriate professional due diligence is carried out to support decision making;*

    - *Reporting and management information (TMP6 and schedules), including where and how often monitoring reports are taken;*

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