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Treasury Management Strategy Statement

and Annual Investment Strategy

2020 - 2025

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 cash flow is adequately planned, with cash being available when it is needed. Short term 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 occasions 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 loans to third parties, commercial investment initiatives or other non-financial investments will impact on the treasury function, these activities are generally classed as non-treasury activities, (arising usually from capital expenditure), and are separate from the day to day treasury management activities.

CIPFA defines treasury management as:

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

1.2 Reporting requirements

1.2.1 Capital Strategy

The CIPFA revised 2017 Prudential and Treasury Management Codes required from 2019-20 for all local authorities to prepare a capital strategy report, which provides the following:

- a high-level longer 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 fully understand the overall longer-term policy objectives and resulting capital strategy requirements, governance procedures and risk appetite.

The Capital Strategy is contained within the 5 year Financial Strategy approved by Council on 17 December 2019.

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) which 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
 - an investment strategy, (the parameters on how investments are to be managed).
- b. **A mid-year treasury management report** – This is primarily a progress report provided to Audit and Governance Committee and will update members on the capital position, amending prudential indicators as necessary, and whether any policies require revision.
- c. **An annual treasury report** – This report is presented to Audit and Governance Committee and will update members with a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy, and whether any policies require revision.

Scrutiny

Scrutiny will be provided by the Audit & Governance Committee

1.3 Treasury Management Strategy for 2020/21 to 2024/25

The strategy 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. Training for Members was last provided in April 2018 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 Asset Services, Treasury solutions as its external treasury management advisors.

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

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

1.6 Introduction of Reporting Standard IFRS16

International Financial Reporting Standard 16 – Leases will come into operation from 1 April 2020. This standard has implications on treasury prudential indicators, particularly the Capital Financing Requirement as well as the Operational Boundary and Authorised Limit.

Work is progressing on the implementation of the new standard and an update of the likely implications will be incorporated into future reporting.

2 THE CAPITAL PRUDENTIAL INDICATORS 2020/21 – 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 as outlined in Table 1 below.

Table 1 – Capital Expenditure

Capital expenditure £'000	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate
General Services	37,519	34,572	96,199	81,480	76,824	72,038	28,966
HRA	22,410	33,429	33,540	37,248	36,747	32,752	33,801
Total	59,929	68,001	129,739	118,728	113,571	104,790	62,767

Other long-term liabilities - the above financing need excludes other long-term liabilities, such as PPP and leasing arrangements that already include borrowing instruments.

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

Table 2 – Financing of Capital Expenditure

Financing of capital expenditure £'000	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate
General Services							
Capital receipts	(3,404)	(9,051)	(28,174)	(16,110)	(21,137)	(23,698)	(9,037)
Capital grants	(12,615)	(11,797)	(19,293)	(17,558)	(24,888)	(30,883)	(14,091)
CFCR	(224)						
General Services Total	(16,243)	(20,848)	(47,468)	(33,668)	(46,025)	(54,581)	(23,128)
HRA							
Capital receipts	(352)	(2,347)	(3,726)				
Capital grants	(7,374)	(7,542)	(3,991)	(4,696)	(4,696)	(4,696)	(2,696)
CFCR	(3,200)	(6,700)	(3,500)	(3,700)	(4,200)	(3,900)	(4,600)
HRA Total	(10,926)	(16,589)	(11,217)	(8,396)	(8,896)	(8,596)	(7,296)
Net financing need for the year	32,760	30,565	71,055	76,664	58,651	41,613	32,342

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.

The CFR includes any other long-term liabilities (e.g. PPP schemes, finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes. The Council currently has £38.244m of such schemes within the CFR and this is included in the table below.

Table 3 – CFR Projections

£'000	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate
Capital Financing Requirement (including PPP & Finance Leases)							
CFR - General Services	264,048	267,686	307,574	347,703	371,753	382,752	382,207
CFR – HRA	187,528	200,567	218,836	243,023	265,699	284,171	304,670
Total CFR	451,576	468,253	526,410	590,726	637,452	666,923	686,877
Movement in CFR	20,058	16,677	58,157	64,316	46,726	29,471	19,954
Movement in CFR represented by							
Net financing need for the year	32,759	30,565	71,055	76,664	58,651	41,613	32,342
GS -Less loan fund repayments and other financing movements	(9,869)	(10,086)	(8,844)	(7,683)	(6,749)	(6,458)	(6,382)
HRA - Less loan fund repayments and other financing movements	(2,832)	(3,802)	(4,054)	(4,665)	(5,186)	(5,684)	(6,006)
Movement in CFR	20,058	16,677	58,157	64,316	46,726	29,471	19,954

2.3 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.

The operation of the loans fund is regulated by statute, with updated regulations: (The Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016 (the 2016 Regulations)) coming into force on 1 April 2016.

- The Council will apply the following strategy for loans fund advances:
 - Any income/receipts applied in year are where possible aligned to shorter life assets or where appropriate to reduce loans fund advances. Any loans fund advances in year is matched to assets with longer economic lives.

General Services

- All capital expenditure incurred from 2001 has been reflected within the loans fund on an individual asset basis, rather than an overall pooled approach.
- All capital expenditure incurred between 2001 and 2016 has been aligned to the asset life which was given at the time capital expenditure had been incurred (i.e. in line with depreciation charged through the Council's statutory accounts). These have been aligned to the asset lives provided for the rolling valuation programme as required by the Council's statutory accounting process.
- From 2016, in line with the statutory guidance, all asset lives have been reviewed and aligned to the estimated economic life of the asset.

HRA

- All capital expenditure incurred from 2001 has been reflected within the loans fund and categorised as new council housing, modernisation expenditure on existing properties and open market acquisitions.
- All capital expenditure incurred between 2001 and 2012-13 has been aligned to the asset life which was given at the time capital expenditure has been incurred (i.e in line with depreciation charged through the Council's statutory accounts).
- From 2013-14, there was a change to the approach required to value Council dwellings through the statutory accounts. As a result, all of the Council dwellings have been depreciated using a pooled approach and given the same life, regardless of each asset's age.

- It is not considered prudent and commensurate with the economic benefit of the asset life to match loans fund advances in such a way. As such, from 2013-14, all of the asset lives have been reviewed, and all HRA loans fund advances are now aligned to the estimated economic life of the asset.

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 is that a revised annuity rate of 4% is a fair and prudent approach and provides principal repayments more closely associated with the use of the assets.

For illustrative purposes, assuming projected expenditure in line with approved plans and further extended to a 10 year period, the General Services and HRA expected loans fund balances are shown below in the tables below.

Table 4 – General Services Loans Fund Balances

General Services £'000	Opening Balance	Advances	Repayments	Closing Balance
Year 1	230,788	48,732	7,299	272,221
Year 2-5	272,221	101,906	21,020	353,107
Year 6-10	353,107	22,350	27,358	348,099
Year 11-15	348,099		34,809	313,290
Year 15-20	313,290		40,068	273,222
Year 21-30	273,222		74,976	198,246
Year 31-40	198,246		48,263	149,983
Year 41-50	149,983		50,690	99,293
Year 51-60	99,293		69,435	29,858
Year 61-70	29,858		29,858	0

Table 5 – HRA Loans Fund Balances

HRA £'000	Opening Balance	Advances	Repayments	Closing Balance
Year 1	200,566	22,323	4,054	218,835
Year 2-5	218,835	107,363	21,530	304,668
Year 6-10	304,668	129,762	36,970	397,460
Year 11-15	397,460		43,123	354,337
Year 16-20	354,337		43,510	310,827
Year 21-30	310,827		71,946	238,881
Year 31-40	238,881		63,231	175,650
Year 41-50	175,650		64,433	111,217
Year 51-60	111,217		75,270	35,947
Year 61-70	35,947		35,947	0

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 Council's treasury portfolio position at 31 March 2019 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.

Table 6 – Treasury Position

£'000	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate
External Debt							
Debt at 1 April	358,025	360,440	373,710	430,487	487,136	532,522	562,889
Expected change in Debt	2,415	13,270	56,776	56,649	45,416	30,337	4,186
Other long-term liabilities (OLTL)	39,723	36,898	36,897	35,352	33,775	32,209	30,682
Expected change in OLTL	(1,479)	(1,347)	(1,545)	(1,577)	(1,566)	(1,473)	(1,583)
Actual gross debt at 31 March	398,684	409,262	465,839	520,911	564,761	593,626	596,174
The Capital Financing Requirement	451,575	466,906	526,409	590,726	637,452	666,976	686,877
Under / (over) borrowing	52,891	57,644	60,570	69,815	72,691	73,350	90,703

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 2020/21 and the following four 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 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 and the ability to fund under-borrowing by other cash resources.

Table 7 – Operational Boundary

Operational boundary £'000	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate
Debt	431,355	491,056	556,950	605,243	636,240	657,777
Other long term liabilities	36,897	35,352	33,775	32,209	30,682	29,099
Total	468,252	526,409	590,725	637,452	666,922	686,876

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

This is the statutory limit (Affordable Capital Expenditure Limit) determined under Regulation 6(1) of the Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016. 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.

Table 8 – Authorised Limit

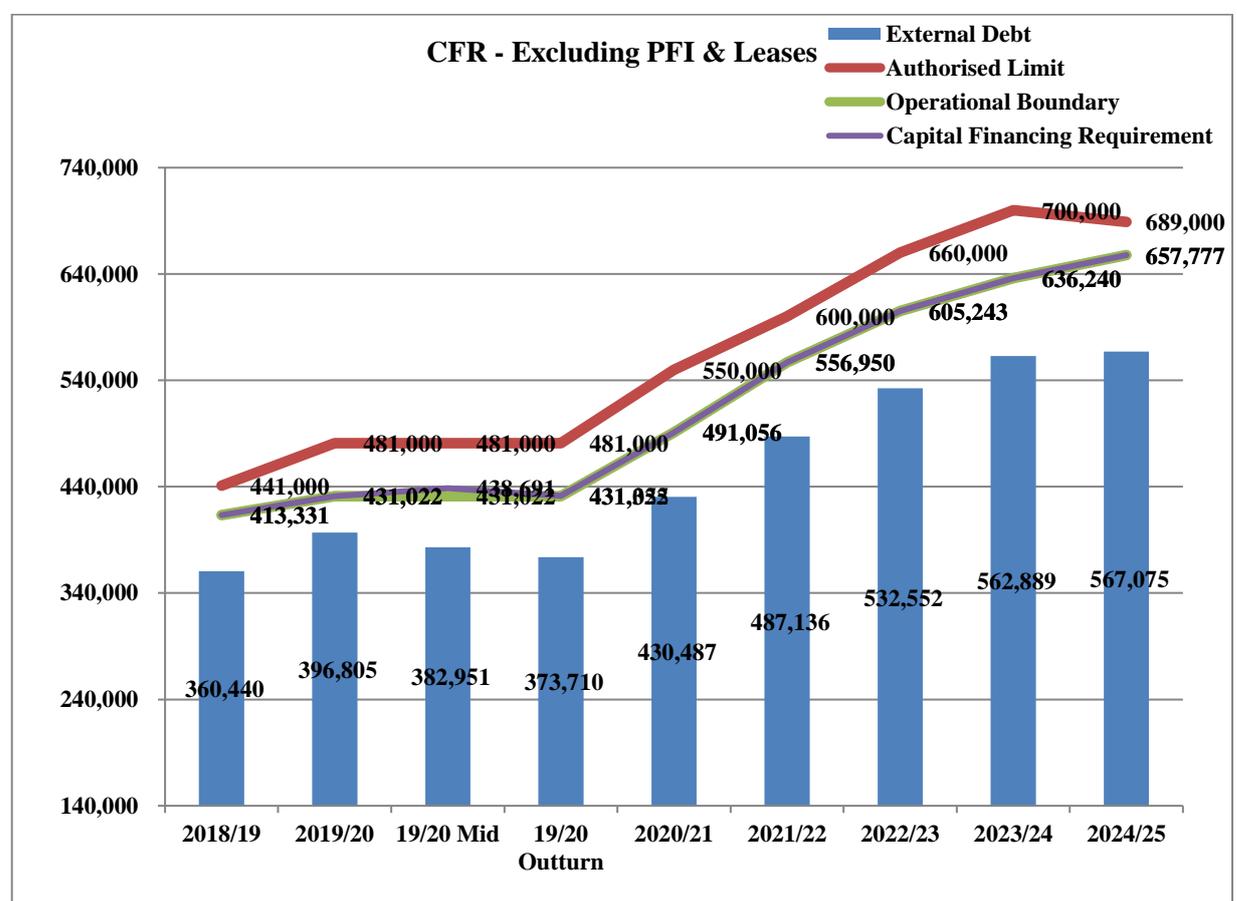
Authorised limit £'000	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate
Debt	481,000	550,000	600,000	660,000	700,000	689,000
Other long term liabilities	37,000	36,000	34,000	33,000	31,000	30,000
Total	518,000	586,000	634,000	693,000	731,000	719,000

These authorised limits are consistent with the Council's current commitments, and approved budget for capital expenditure and financing. The limits are based on the estimate of the most likely, but prudent but not worst-case scenario with, and includes sufficient headroom over and above this to allow for the operational management of unusual cash flows, such as debt restructuring, or timing issues with expected capital income.

The graphs below shows the actual debt and CFR with reference to the tables above.

Table 9 - External Debt, CFR, Operational Boundary and Authorised Limit

Detail	2018/19	2019/20	19/20 Mid	19/20 Outturn	2020/21	2021/22	2022/23	2023/24	2024/25
Authorised Limit	441,000	481,000	481,000	481,000	550,000	600,000	660,000	700,000	689,000
Operational Boundary	413,331	431,022	431,022	431,022	491,056	556,950	605,243	636,240	657,777
Capital Financing Requirement	413,331	431,022	438,691	431,355	491,056	556,950	605,243	636,240	657,777
External Debt	360,440	396,805	382,951	373,710	430,487	487,136	532,552	562,889	567,075



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.

Table 10 – Interest Rate Projections

These forecasts are based on an assumption that there is an agreed deal on the terms of trade between the UK and EU, at some point in time. The result of the December 2019 general election has removed much uncertainty around this major assumption, but there remains risks to interest rate projections pending clarity on whether an agreement can be reached with the EU on a trade deal by December 2020.

Link Asset Services Interest Rate View													
	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
Bank Rate View	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25	1.25	1.25	1.25
3 Month LIBID	0.70	0.70	0.80	0.80	0.90	1.00	1.00	1.10	1.20	1.30	1.30	1.30	1.30
6 Month LIBID	0.80	0.80	0.90	1.00	1.00	1.10	1.20	1.30	1.40	1.50	1.50	1.50	1.50
12 Month LIBID	0.90	0.90	1.00	1.10	1.20	1.30	1.40	1.50	1.60	1.70	1.70	1.70	1.70
5yr PWLB Rate	2.30	2.30	2.40	2.40	2.50	2.60	2.70	2.80	2.90	2.90	3.00	3.00	3.10
10yr PWLB Rate	2.50	2.50	2.60	2.60	2.70	2.80	2.90	3.00	3.10	3.10	3.20	3.20	3.30
25yr PWLB Rate	3.00	3.00	3.10	3.20	3.30	3.40	3.50	3.60	3.70	3.80	3.80	3.90	3.90
50yr PWLB Rate	2.90	2.90	3.00	3.10	3.20	3.30	3.40	3.50	3.60	3.70	3.70	3.80	3.80
Bank Rate													
Link Asset Services	0.75%	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.25%
Capital Economics	0.75%	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	-	-	-	-	-
5yr PWLB Rate													
Link Asset Services	2.30%	2.30%	2.40%	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%
Capital Economics	2.40%	2.50%	2.50%	2.60%	2.60%	2.80%	2.80%	2.90%	-	-	-	-	-
10yr PWLB Rate													
Link Asset Services	2.50%	2.50%	2.60%	2.60%	2.70%	2.80%	2.90%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%
Capital Economics	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%	3.00%	3.10%	-	-	-	-	-
25yr PWLB Rate													
Link Asset Services	3.00%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.60%	3.70%	3.80%	3.80%	3.90%	3.90%
Capital Economics	3.10%	3.10%	3.20%	3.20%	3.20%	3.30%	3.30%	3.40%	-	-	-	-	-
50yr PWLB Rate													
Link Asset Services	2.90%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.60%	3.70%	3.70%	3.80%	3.80%
Capital Economics	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%	3.40%	3.50%	-	-	-	-	-

PWLB rates.

In the first half of 2019-20 longer term PWLB borrowing rates fell to exceptionally low levels due to economic uncertainty, however, on 9 October 2019, the Treasury and PWLB announced a full 1% increase on all new borrowing. The PWLB forecasts will be subject to change over the next year as a result of the external influences on them.

Investment and borrowing rates

Investment returns are likely to remain low during 2020/21 with little increase in the following two years.

On 9 October 2019, the Treasury and PWLB announced a 1% increase in the PWLB rate for all new borrowing, with immediate effect and without any warning. In recent years, the Council has predominately used PWLB as its

main source of funding partly due to the level of risk and interest rates available. An anticipated increase in interest rates had already been included within future capital investment plans, but there will now be a requirement to consider alternative sources of borrowing in order to achieve the best rates and terms. Whilst it remains unclear as to any further increase in borrowing rates, the Council's treasury advisor, Link Asset Services is currently forecasting that all PWLB rates are likely to increase over the next few years.

While the Council is not able to avoid borrowing to finance new capital expenditure or replace maturing debt, there will be a cost of carry, (the difference between higher borrowing costs and lower investment returns), to any new short or medium-term borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost.

3.4 Borrowing strategy

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

There remains risks within the economic forecast, particularly relating to interest rate fluctuations and these will be closely monitored, and should any change be necessary, the Head of Council Resources will adopt a pragmatic approach to changing circumstances as set out below:

- 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 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, then the portfolio position will be re-assessed. 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 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.

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 the 100 bps increase in PWLB rates only applied to new borrowing rates and not to premature debt repayment rates.

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

3.7 New financial institutions as a source of borrowing and / or types of borrowing

The Council may also consider, subject to treasury advisor advice and creditworthiness checks, borrowing from new financial institutions where these are considered to meet Environmental, Social and Governance (ESG) criteria where the terms and rates offered are competitive.

Following the decision by the PWLB on 9 October 2019 to increase their borrowing rates, consideration will also need to be given to sourcing funding at cheaper rates from the following:

- Local authorities (primarily shorter dated maturities)
- Financial institutions (primarily insurance companies and pension funds but also some banks)
- Municipal Bonds Agency

The degree to which any of these options may prove cheaper than the PWLB certainty rate is still evolving but our treasury advisors will keep us informed.

4 ANNUAL INVESTMENT STRATEGY

4.1 Investment policy

The Council's investment policy implements the requirements of the Local Government Investments (Scotland) Regulations 2010, (and accompanying Finance Circular 5/2010), and the CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2017, ("the CIPFA TM Code").

The above regulations and guidance place a high priority on the management of risk. The Council's investment priorities will be security first, liquidity second and then return. The Council 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 5.2. Appendix 5.3 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 in Table 11 in paragraph 4.2.
6. **Transaction limits** are set for each type of investment in appendix 5.3.
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 2019/20 under **IFRS 9**, this authority will consider the implications of investment instruments which could result in an adverse movement in the value of the amount invested and resultant charges at the end of the year to the General Fund. (This area is currently under review by LASAAC and the Scottish Government. Members will be updated on any potential implications.)
12. This authority will also consider investments where the investment, subject to Item 9 above is considered to be a socially responsible investment by meeting Environmental, Social and Governance (ESG) criteria.
13. Regular monitoring of investment performance will be carried out during the year.

4.2 Creditworthiness policy

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

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

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

- 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 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 weekly. The Council is alerted to changes to ratings of all three agencies through its use of our creditworthiness service.

- if a downgrade results in the counterparty / investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
- in addition to the use of credit ratings the Council will be advised of information in movements in credit default swap spreads against the iTraxx benchmark and other market data on a daily basis via its Passport website, provided exclusively to it by Link Asset Services. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.
- Sole reliance will not be placed on the use of this external service. In addition this Council will also use market data and market information, information on sovereign support for banks and the credit ratings of that supporting government.

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

Table 11 – Counterparty Investment Rating and Limits

	Colour (and long term rating where applicable)	Money and/or % Limit	Time Limit
Banks * (UK Government collateral)	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	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 1.50	Light pink / AAA	£5m	liquid

Balances held overnight with the Councils bank are reviewed on a daily basis

UK banks – ring fencing

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

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

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

4.3 Country and sector limits

The Council has determined that it will only use approved counterparties from the UK and from countries with a minimum sovereign credit rating of AA from Fitch (or equivalent). The list of countries that qualify using this credit criteria as at the date

of this report are shown in Appendix 5.4. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

4.4 Investment strategy

In-house funds. Investments will only 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

On the assumption that the UK and EU agree a Brexit deal including the terms of trade by the end of 2020 or soon after, then Bank Rate is forecast to increase only slowly over the next few years to reach 1.00% by quarter 1 2023. Bank Rate forecasts for financial year ends (March) are:

- Q1 2021 0.75%
- Q1 2022 1.00%
- Q1 2023 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:

- 2019/20 0.75%
- 2020/21 0.75%
- 2021/22 1.00%
- 2022/23 1.25%
- 2023/24 1.50%
- 2024/25 1.75%
- Later years 2.25%

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

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

Table 12 – Upper limit for Investments >365 days

Upper limit for principal sums invested for longer than 365 days			
£m	2020/21	2021/22	2022/23
Principal sums invested for longer than 365 days	£10m	£10m	£10m

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

The East Lothian Common Good funds and Charitable Trust funds are managed in two separate portfolios by an external investment management company - Investec. At 31 December 2019, the East Lothian Charitable Trust portfolio was valued at £3.658m while the Common Good portfolio was valued at £3.728m. 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. Treasury management practice TMP1 – permitted investments
3. Treasury management practice TMP1 – credit and counterparty risk management
4. Approved countries for investments
5. Treasury management scheme of delegation
6. The treasury management role of the section 95 officer

5.1 THE CAPITAL PRUDENTIAL AND TREASURY INDICATORS 2020/21 – 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 £'000	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate
General Services	37,519	34,572	96,199	81,480	76,824	72,038	28,966
HRA	22,410	33,429	33,540	37,248	36,747	32,752	33,801
Total	59,929	68,001	129,739	118,728	113,571	104,790	62,767

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	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate
GS Revenue Stream	230,577	238,805	252,992	257,880	263,380	269,312	275,711
GS Financing Costs	16,000	16,000	15,250	15,250	15,500	16,000	16,000
General Services	6.94%	6.70%	6.03%	5.91%	5.89%	5.94%	5.80%
HRA Revenue Stream							
HRA Revenue Stream	30,159	31,862	34,201	36,269	38,625	40,759	42,746
HRA Financing Costs	9,000	10,190	10,915	12,082	13,403	14,663	15,524
HRA	29.84%	31.98%	31.92%	33.31%	34.71%	35.97%	36.32%

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

b. General Services ratios

	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate
General Services Debt £'000	225,804	230,789	272,222	313,928	339,544	352,070	353,108
Band D Equivalents	48,047	49,416	50,516	51,616	52,716	53,816	54,916
Debt per Band D Equivalent £	£4,670	£4,670	£5,389	£6,082	£6,441	£6,542	£6,430

c. HRA ratios

	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate
HRA debt £'000	187,528	200,567	218,836	243,022	265,699	284,170	304,669
Number of HRA dwellings £m	8,740	8,850	8,941	9,116	9,207	9,388	9,546
Debt per dwelling £	£21,456	£22,663	£24,476	£26,659	£28,858	£30,270	£31,915

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.

Maturity structure of fixed interest rate borrowing 2020/21		
	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%
Over 40 years	0%	75%
Maturity structure of variable interest rate borrowing 2020/21		
	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%
Over 40 years	0%	20%

5.1.4. Control of interest rate exposure

Please see paragraphs 3.3, 3.4 and 4.4.

%	2020/21	2021/22	2022/23	2023/24	2024/25
Interest rate exposures					
	Upper	Upper	Upper	Upper	Upper
Limits on fixed interest rates based on net debt	100%	100%	100%	100%	100%
Limits on variable interest rates based on net debt	40%	40%	40%	40%	40%

5.2 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: -

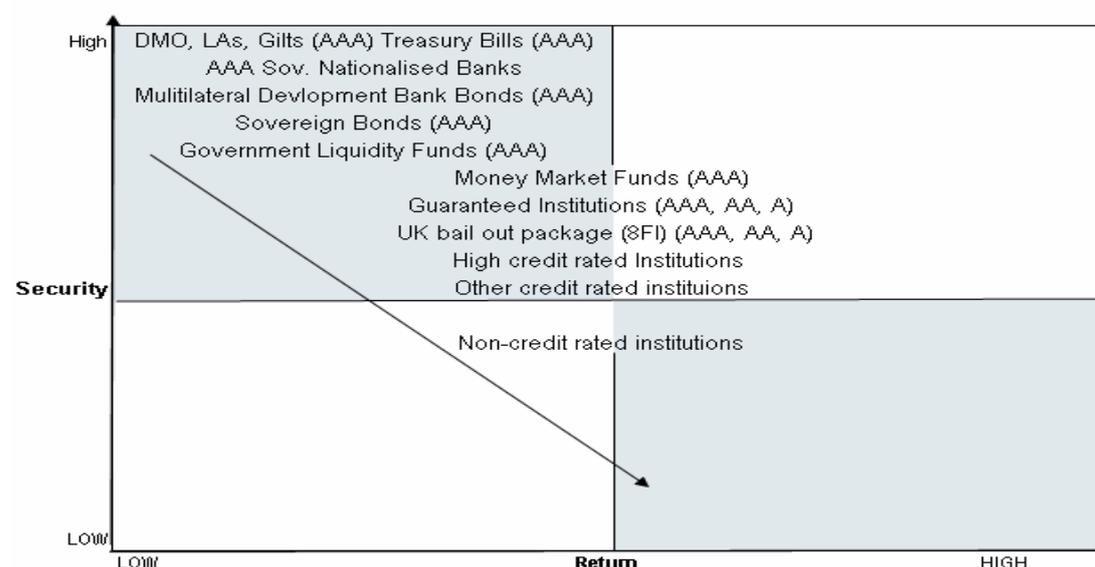
1. **Credit and counter-party risk:** this is the risk of failure by a counterparty (bank or building society) to meet its contractual obligations to the organisation particularly as a result of the counterparty's diminished creditworthiness, and the resulting detrimental effect on the organisation's 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.
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

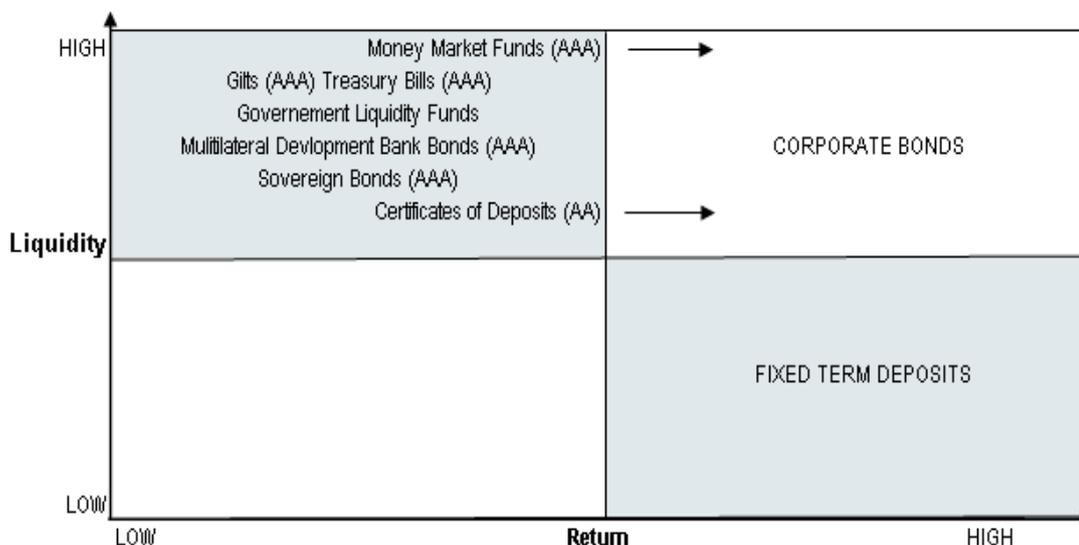
1. **Credit and counter-party risk:** this authority has set minimum credit criteria to determine which counterparties and countries are of sufficiently high creditworthiness to be considered for investment purposes. See paragraphs 4.2 and 4.3.
2. **Liquidity risk:** this authority has a cash flow forecasting 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 also complied with all regulations.

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



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



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 (DMADF).** 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.

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 the 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 (DMADF).** 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 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. 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. 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. 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 UK 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 Government) 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. 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 that 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 AAmmf from Fitch or a rating of AAAm with Standard & Poors.

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 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 Government)	AAA	Sale T+1	yes	20%	5 yrs
Bonds issued by multilateral development banks	AAA	Sale T+1	yes	20%	5 yrs

1.4 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.

1.5 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

5.3 TREASURY MANAGEMENT PRACTICE (TMP1): CREDIT AND COUNTERPARTY RISK MANAGEMENT

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
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.	As shown in the 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 shown in the 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 shown in the 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 shown in the counterparty criteria above.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits
a. 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 shown in the counterparty criteria above
b. 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 shown in the 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 Head of Council Resources, 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 4.6.

5.4 APPROVED COUNTRIES FOR INVESTMENTS

This list is based on countries which have sovereign ratings of AA- or higher, (Link show the lowest rating from Fitch, Moody's and Standard & Poors) 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.

Based on lowest available rating

AAA

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

AA+

- Finland
- U.S.A.

AA

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

AA-

- Belgium
- Qatar

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.
- 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

- recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance;
- submitting regular treasury management policy reports;
- submitting budgets and budget variations;
- receiving and reviewing management information reports;
- reviewing the performance of the treasury management function;
- ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function;
- ensuring the adequacy of internal audit, and liaising with external audit;
- recommending the appointment of external service providers.
- preparation of a capital strategy to include capital expenditure, capital financing, non-financial investments and treasury management, with a long term timeframe.
- ensuring that the capital strategy is prudent, sustainable, affordable and prudent in the long term and provides value for money
- ensuring that due diligence has been carried out on all treasury and non-financial investments and is in accordance with the risk appetite of the authority
- ensure that the authority has appropriate legal powers to undertake expenditure on non-financial assets and their financing
- ensuring the proportionality of all investments so that the authority does not undertake a level of investing which exposes the authority to an excessive level of risk compared to its financial resources
- ensuring that an adequate governance process is in place for the approval, monitoring and ongoing risk management of all non-financial investments and long term liabilities
- provision to members of a schedule of all non-treasury investments including material investments in subsidiaries, joint ventures, loans and financial guarantees ensuring that members are adequately informed and understand the risk exposures taken on by an authority
- ensuring that the authority has adequate expertise, either in house or externally provided, to carry out the above