APPENDIX 1

SCOTTISH BORDERS COUNCIL

TREASURY MANAGEMENT STRATEGY
(incorporating the Annual Investment Strategy)

2012/13

Finance
Resources Department
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CONTENTS

1 Purpose and Scope

1.1 The Council is required to receive and approve, as a minimum, three main reports on Treasury activity each year, which incorporate a variety of policies, estimates and actuals. These reports are required to be adequately scrutinised by committee before being recommended to the Council. This role is undertaken by the Audit Committee.

1.2 This is the first, and most important of these reports, and covers:

a) The Capital Plans of the Council (including prudential indicators);

b) The Treasury Management Strategy (how the investments and borrowings are organised) including treasury indicators; and

c) An Investment Strategy (the parameters on how investments are to be managed).

1.3 The remaining two reports are the Mid Year Treasury Management Report and the Annual Treasury Report.

1.4 The Treasury Management issues covered by this report include:

- the current treasury position;
- treasury indicators which will 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.

1.5 These elements cover the requirements of the Local Government in Scotland Act 2003, the CIFPA Prudential Code, the CIPFA Treasury Management Code (the CIPFA Code) and the Scottish Government Investment Regulations.

1.6 The Treasury Management Strategy covers the treasury management activities for the Council, the Scottish Borders Council Pension Fund, the Common Goods and the Trust Funds which are managed by the Council.

2 Background

2.1 The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. A major aspect 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.

2.2 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.

2.3 The Prudential and Treasury Indicators (summarised in **Annex A**) consider the affordability and impact of capital expenditure decisions, and set out the Council's overall capital framework. These Indicators have been developed in line with the CIPFA Code. The treasury service considers the effective funding of these decisions. Together they form part of the process which ensures the Council meets its balanced budget requirement under the Local Government Finance Act 1992.

2.4 CIPFA defines treasury management as:

"The management of the local authority's 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. "

3 The Capital Prudential Indicators 2012/13 – 2014/15

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

3.1 Capital Expenditure (Prudential Indicator PI-1)

a) This prudential Indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of the 2012/13 financial planning cycle. The Capital Financial Plan 2012/13 – 2021/22 includes the following capital expenditure forecasts:

Capital Expenditure (PI-1) £m	2010/11 Actual	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Engineering Infrastructure	12.2	12.0	11.7	7.6	6.9
Land & Property	11.0	14.7	11.7	9.5	6.1
Business Infrastructure	1.4	3.1	1.8	4.2	6.7
Fleet	1.4	2.7	2.7	2.2	3.7
Other	1.1	0.5	0.8	0.8	0.8
Total	**27.1**	**33.0**	**28.7**	**24.3**	**24.2**

3.2 Other Long Term Liabilities

a) The financing need identified above in paragraph 3.1 a) excludes other long term liabilities, such as Public Private Partnerships (PPP) and leasing arrangements which already include borrowing instruments. The proposed Financial Plans for 2012/13 include the commencement of the operation of the Easter Langlee Waste Treatment Plant which is a PPP project. The impact of this on other long term liabilities will be as follows:

Other Long Term Liabilities £m	2010/11 Actual	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Waste Treatment Plant	0	0	0	16.2	0

3.3 Other Relevant Expenditure

a) The Council has, and anticipates to have, additional expenditure which will be eligible for consideration as Capital Expenditure for the purposes of the Treasury and Prudential Indicators. This expenditure relates to initiatives where the Council has or is planning to apply for a Consent to Borrow from the Scottish Government. The two key areas not included in paragraph 3.1 or 3.2 above are the planned borrowing to fund lending to the National Housing Trust (NHT) (approved by Council 10 February 2011) and the proposed lending to Registered Social Landlords (RSLs) (approved by Council 15 December 2011). The consent has been received for the NHT borrowing, but no application has yet been made for the RSLs and the estimated amounts are as follows:

Other Relevant Expenditure £m	2010/11 Actual	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Icelandic Banks	1.3	0.0	0.0	0.0	0.0
Early Retiral/Voluntary Severance	1.0	0.0	0.0	0.0	0.0
National Housing Trust (NHT)	0.0	0.0	4.0	0.0	0.0
Registered Social Landlords	0.0	0.0	5.0	0.0	0.0
Total	**2.3**	**0.0**	**9.0**	**0.0**	**0.0**

3.4 Capital Financing Assumptions

a) 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 financing need (borrowing).

Capital Expenditure £m	2010/11 Actual	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Capital Expenditure	27.1	33.0	28.7	24.3	24.2
Other Relevant Expenditure	2.3	0.0	9.0	0.0	0.0
Total Expenditure	**29.4**	**33.0**	**37.7**	**24.3**	**24.2**
Financed by:					
Capital receipts	3.6	0.4	1.4	0.1	0.0
Developer Contributions	0.4	0.2	0.1	0.1	0.1
Govt. General Capital Grants	5.9	11.9	9.1	8.5	13.0
Govt. Specific Capital Grants	0.6	0.3	0.1	0.1	0.2
Other Grants & Contributions	0.3	1.3	1.5	1.2	4.0
Borders Railway Capital Grant	3.9	3.4	1.3	0.0	0.0
Plant & Vehicle Fund	1.3	2.6	2.7	2.2	2.9
Net financing need for the year	**13.4**	**12.9**	**21.5**	**12.1**	**4.0**

3.5 The Council's Borrowing Need (the Capital Financing Requirement – Prudential Indicator PI-2)

a) 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 identified above, which has not immediately been paid for (e.g. via grants), will increase the CFR.

b) Following accounting changes the CFR includes any other long term liabilities (e.g. PPP schemes, finance leases) brought onto the balance sheet. Whilst this increases 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 £60.3m of such schemes within the 2011/12 CFR.

c) The Council is asked to approve the CFR projections below:

Capital Financing Requirement (PI-2) £m	2010/11 Actual	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Total CFR (PI-2)	**262.9**	**265.5**	**276.8**	**294.7**	**288.7**
Movement in CFR represented by:					
Net financing need for the year (above)		12.9	21.5	12.1	4.0
Less scheduled debt amortisation and other financing movements		(10.3)	(10.2)	5.8	(10.0)
Movement in CFR		**2.6**	**11.3**	**17.9**	**(6.0)**

3.6 Affordability Prudential Indicators

a) 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 updated indicators are as follows:

(i) **Actual and estimates of the ratio of financing costs to net revenue stream. (Prudential Indicator PI-3)**

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.

%	2010/11 Actual	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Ratio of Financing Costs to Net Revenue Stream (PI-3)	9.33	8.80	9.59	9.84	10.31

The estimates of financing costs include current commitments and the proposals in the Financial Plans for 2012/13.

(ii) **Estimates of the incremental impact of capital investment decisions on council tax. (Prudential Indicator PI-4)**

This indicator identifies the revenue costs associated with proposed changes to the operational three year capital programme recommended in this budget report compared to the Council's existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates, such as the level of Government support, which are not published over a three year period.

Incremental Impact Of Capital Investment Decisions On The Band D Council Tax (PI-4):

£	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Council tax - band D	(0.04)	(0.01)	(0.01)	(0.01)

4 Treasury Management Strategy

The capital expenditure plans set out in Section 3.1 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.

4.1 Current Portfolio Position

a) The Council's treasury portfolio position at 31 March 2011, with forward projections is summarised below. The table shows the actual external borrowing, against the capital borrowing need (the CFR), highlighting any over or under borrowing.

£m	2010/11 Actual	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
External Debt:					
Borrowing at 1 April		166.7	176.3	197.7	209.7
Expected change in borrowing		9.6	21.4	12.0	4.0
Borrowing at 31 March	**166.7**	**176.3**	**197.7**	**209.7**	**213.7**
Other long-term liabilities (OLTL) at 1 April		62.2	60.3	58.5	73.0
Expected change in OLTL		(1.9)	(1.8)	14.5	(2.0)
OLTL at 31 March	**62.2**	**60.3**	**58.5**	**73.0**	**71.0**
Total Actual External Debt at 31 March (Prudential Indicator PI-5)	**228.9**	**236.6**	**256.2**	**282.7**	**284.7**
Investments:					
Total investments at 1 April		(16.3)	(10.3)	(9.9)	(9.5)
Expected change in Investments		6.0	0.4	0.4	0.4
Investments at 31 March	**(16.3)**	**(10.3)**	**(9.9)**	**(9.5)**	**(9.1)**
Net borrowing	**212.6**	**226.4**	**246.3**	**273.2**	**275.6**
CFR – the borrowing need (see (b) below)	**277.1**	**294.7**	**288.7**	**294.5**	**297.4**
(Under) / over borrowing (Prudential Indicator PI-6)	**(64.5)**	**(68.3)**	**(42.4)**	**(21.3)**	**(21.8)**

b) 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 (PI-6) is that the Council needs to ensure that its total borrowing, net of any investments, (shown as net borrowing above) 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 2012/13 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing in advance of need is not undertaken for revenue purposes.

c) It is confirmed by the Chief Financial Officer 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 the Financial Plans 2012/13.

4.2 Treasury Indicators: Limits to Borrowing Activity

a) The Operational Boundary (Prudential Indicator PI-7)

This is the limit beyond which external borrowing 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 borrowing.

Operational boundary £m	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Total Operational Boundary (PI-7a)	**261.3**	**272.3**	**288.0**	**287.9**
Less: Other long term liabilities	(60.3)	(58.5)	(73.0)	(71.0)
Operational Boundary exc. Other Long Term Liabilities (PI-7b)	**201.0**	**213.8**	**215.0**	**216.9**

b) The Authorised Limit For External Borrowing(Prudential Indicator PI-8)

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

(ii) 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 Local Authority plans, or those of a specific council, although this power has not yet been exercised.

(iii) The proposed Authorised Limit for the Council is as follows:

Authorised Limit £m	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Total Authorised Limit (PI-8a)	**289.7**	**304.7**	**323.9**	**318.2**
Less: Other long term liabilities	(60.3)	(58.5)	(73.0)	(71.0)
Authorised Limit exc. Other Long Term Liabilities (PI-8b)	**229.4**	**246.2**	**250.9**	**247.2**

4.3 Prospects for Interest Rates

a) The Council has appointed Sector as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. **Annex B** draws together a number of current City forecasts for short term (Bank Rate) and longer fixed interest rates. The following table gives the Sector central view.

Annual Average %	Bank Rate	Money Rates		PWLB Borrowing Rates		
		3 month	1 year	5 year	25 year	50 year
March 2012	0.50	0.70	1.50	2.30	4.20	4.30
June 2012	0.50	0.70	1.50	2.30	4.20	4.30
Sept 2012	0.50	0.70	1.50	2.30	4.30	4.40
Dec2012	0.50	0.70	1.60	2.40	4.30	4.40
March 2013	0.50	0.75	1.70	2.50	4.40	4.50
June 2013	0.50	0.80	1.80	2.60	4.50	4.60
Sept 2013	0.75	0.90	1.90	2.70	4.60	4.70
Dec 2013	1.00	1.20	2.20	2.80	4.70	4.80
March 2014	1.25	1.40	2.40	2.90	4.80	4.90
June 2014	1.50	1.60	2.60	3.10	4.90	5.00

b) Growth in the UK economy is expected to be weak in the next two years and there is a risk of a technical recession (i.e. two quarters of negative growth). Bank Rate, currently 0.5%, underpins investment returns and is not expected to start increasing until quarter 3 of 2013 despite inflation currently being well above the Monetary Policy Committee inflation target. Hopes for an export led recovery appear likely to be disappointed due to the Eurozone sovereign debt crisis depressing growth in the UK's biggest export market. The Comprehensive Spending Review, which seeks to reduce the UK's annual fiscal deficit, will also depress growth during the next few years.

c) Fixed interest borrowing rates are based on UK gilt yields. The outlook for borrowing rates is currently much more difficult to predict. The UK total national debt is forecast to continue rising until 2015/16; the consequent increase in gilt issuance is therefore expected to be reflected in an increase in gilt yields over this period. However, gilt yields are currently at historically low levels due to investor concerns over Eurozone sovereign debt and have been subject to exceptionally high levels of volatility as events in the Eurozone debt crisis have evolved.

d) This challenging and uncertain economic outlook has a several key treasury mangement implications:

- The Eurozone sovereign debt difficulties, most evident in Greece, provide a clear indication of much higher counterparty risk. This continues to suggest the use of higher quality counterparties for shorter time periods;
- Investment returns are likely to remain relatively low during 2012/13;
- Borrowing interest rates are currently attractive, but may remain low for some time. The timing of any borrowing will need to be monitored carefully;

e) There will remain a cost of carrying capital because any borrowing undertaken that results in an increase in investments will incur a revenue loss between borrowing costs and investment returns.

f) **Annex C** contains a more comprehensive Economic Background narrative from Sector.

4.4 Borrowing Strategy 2012/13

a) The Council is currently maintaining an under-borrowed position, although did undertake additional long term borrowing (£7.5m) in December 2011. This means that the capital borrowing need (the CFR), has not been fully funded by loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. This strategy remains both prudent and cost effective as investment returns are low and counterparty risk is high. Over the medium term there is an anticipated reduction in capital support from central government and the Council's aim is to assume it does not over borrow against future capital expenditure levels.

b) Against this background and the risks within the economic forecast, caution will be adopted with the 2012/13 treasury operations. The Chief Financial Officer will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

(i) *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.

(ii) *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 a greater than expected increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates were still relatively cheap.

c) Any decisions will be reported to Members at the next available opportunity.

d) Treasury Management Limits on Activity

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

(i) **Upper limits on fixed interest rate exposure. (Treasury Indicator TI-1)**

This is similar to the previous indicator and covers a maximum limit on fixed interest rates;

(ii) **Upper limits on variable interest rate exposure. (Treasury Indicator TI-2)**

This identifies a maximum limit for variable interest rates based upon the debt position net of investments;

(iii) **Maturity structure of borrowing. (Treasury Indicator TI-3)**

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.

(iv) The following table highlights the proposed indicators for the Treasury Management Strategy:

£m	2012/13	2013/14	2014/15
Interest rate Exposures			
	Upper	**Upper**	**Upper**
Limits on fixed interest rates based on net debt (TI-1)	272.3	288.0	287.9
Limits on variable interest rates based on net debt (TI-2)	95.3	100.8	100.8
Maturity Structure of fixed interest rate borrowing 2012/13 (TI-3)			
		Lower	**Upper**
Under 12 months		0%	20%
12 months to 2 years		0%	20%
2 years to 5 years		0%	20%
5 years to 10 years		0%	20%
10 years and above		20%	100%

4.5 Policy on Borrowing in Advance of Need

a) 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.

b) Borrowing in advance may only be undertaken in circumstances where it can be demonstrated that, over the medium term, the borrowing will only be for the purposes of funding capital. This requires the Council to demonstrate that borrowing does not, except in the short term, exceed the total CFR in the preceding year plus the estimates of any additional CFR for the current and following twelve month period.

c) Borrowing in advance is defined as any borrowing undertaken by the local authority which will result in the total external debt of the local authority exceeding the capital financing requirement (CFR) of the local authority for the following twelve month period. This twelve month period is on a rolling twelve month basis.

d) The Chief Financial Officer has the authority to borrow in advance of need under delegated power where, for instance, a sharp rise in interest rates is expected, and so borrowing early at fixed interest rates will be economically beneficial or meet budgetary constraints. The Chief Financial Officer will adopt a cautious approach to any such borrowing, and a business case to support the decision making process must consider:

   (i) the benefits of borrowing in advance,

   (ii) the investment risks created by the existence of investments at the same time as additional borrowing being outstanding, and

   (iii) how far in advance it is reasonable to borrow considering the risks identified.

e) Any such advance borrowing should be reported through the mid-year or annual Treasury Management reporting mechanism.

4.6 Debt Rescheduling

a) 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).

b) The reasons for any rescheduling to take place will include:

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

c) 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.

d) All rescheduling will be reported to the **Executive** at the earliest meeting following its action.

5 Investment Strategy 2012/13

5.1 Investment Objectives and Policy

a) The Council's investment policy has regard to the Local Government Investment (Scotland) Regulations (and accompanying finance circular) and the CIPFA Code.

b) The primary objectives of the Council's investment strategy are:

(i) the safeguarding or **security** of the re-payment of the principal and interest of investments on a timely basis; and
(ii) the **liquidity** of its investments.

c) The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of this Council is low in order to give priority to security of its investments.

d) The borrowing of monies purely to invest or on-lend, without relevant Scottish Government consent, and make a return is unlawful and this Council will not engage in such activity.

e) The Council will ensure:

(i) It maintains a policy covering the categories of investment types it will invest in, the minimum acceptable credit criteria for choosing investment counterparties with adequate security, and the monitoring of their security. The creditworthiness methodology used to create the counterparty list fully accounts for the ratings and watches published by all three ratings agencies with a full understanding of what the ratings reflect in the eyes of each agengy. Using the Sector ratings service banks' ratings are monitored on a real time basis with knowledge of any changes notified electronically as the agencies notify modifications

(ii) It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's Prudential Indicators covering the maximum principal sums invested.

f) The aim of the strategy is to generate a list of highly creditworthy counterparties which will also enable divesification and thus avoidance of concentration risk.

g) The intention of the strategy is to provide security of investment and minimisation of risk.

5.2 Policy On Longer-Term Investments

a) With the introduction of The Local Government Investments (Scotland) Regulations 2010, investments by Scottish local authorities were no longer limited to one year. This Council accordingly wishes to be able to make use of this new power at times when such investing is both appropriate and attractive.

b) The longer cash is invested for, the longer the period during which an institution holding the Council's money could potentially default. This Council will manage such risk exposure by requiring a higher level of creditworthiness for all institutions with which money is placed for periods in excess of one year. This higher level of creditworthiness will not be solely dependent on the use of credit ratings but will also take into account Credit Default Swap (CDS) spreads and other information.

c) In addition, longer term investments are subject to greater interest rate risk in as much as there is more potential during a longer period for interest rates to move unexpectedly compared to the expectations at the time the investment was made. This Council 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 the control of risk

5.3 Council Permitted Investments

a) The Code on the Investment of Money by Local Authorities requires the Council approval of all the types of investments to be used and set appropriate limits for the amount that can be held in each investment type. These types of investments are termed **Permitted Investments** and any investments used which have not been approved as a permitted investment will be considered ultra vires.

b) The permitted investments instruments which may be used in the forthcoming year are detailed in **Annex D**, and include the following:

Cash type instruments

- Deposits with the Debt Management Account Facility (DMADF) (UK Government);
- Deposits with other local authorities or public bodies;
- Money Market Funds;
- Call account deposit accounts with financial institutions (banks and building societies) meeting Creditworthiness Policy;
- Term deposits with financial institutions (banks and building societies) meeting Creditworthiness Policy;
- UK Government Gilts and Treasury Bills;

Other investments

- Investment properties;
- Loans to third parties, including soft loans;
- National Housing Trust
- Pooled Investment Vehicles

c) Details of the risks, mitigating controls and limits associated with each of these permitted categories are shown in **Annex D.**

d) Common Good and Pension Fund permitted investments are also shown at **Annex D**, and where applicable the same counterparty selection criteria as below will be applied.

e) The Treasury Management Strategy only applies to the funds managed in-house for the Pension Fund, as the externally invested funds are covered by the Statement of Investment Principles and other associated policy documents.

5.4 Creditworthiness Policy

a) For those permitted cash type investments managed in-house, the Chief Financial Officer will maintain a counterparty list in compliance with the following Investment Counterparty Selection Criteria. These criteria will be reviewed and revised as considered necessary and submitted to Committee for approval as necessary. This counterparty criteria sets out the method for selecting appropriate counterparties which the Council will choose from, rather than defining what its investments are.

b) The Chief Financial Officer will maintain a counterparty list consistent with the Investment Counterparty Selection Criteria and will revise the criteria and submit them to Committee for approval as necessary. In addition the types of investment to be made needs to be set out (Permitted Investments).

c) The rating criteria use **the lowest common denominator method** of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution (from Fitch, Standard & Poors and Moody's credit rating agencies). For instance if an institution is rated by three agencies, two meet the Council's criteria, the other does not, the institution will fall outside the lending criteria and no investments will be placed with that institution. This is in compliance with a CIPFA Treasury Management Panel recommendation in March 2009 and the CIPFA Treasury Management Code of Practice.

d) Surplus funds may from time to time be placed in Permitted Investments with institutions that satisfy the Council's credit rating criteria applying the lowest common denominator principle to the three international rating agencies.

5.5 Counterparty Selection Criteria

a) These institutions must either be UK Local Authorities or UK Incorporated Institutions, UK Building Societies and Banks incorporated in the European Economic Area entitled to accept deposits through a branch in the UK. The Council may also use the UK Government including in the form of gilts and the Debt Management Account Deposit Facility (DMADF).

b) The criteria for providing a pool of high quality investment counterparties is:

High Credit Quality

c) The Council's current minimum credit rating limits for individual institutions are:

	Standard & Poors	Moodys	Fitch
Short-Term Debt Rating	A-1	P-1	F1
Long-Term Debt Rating	A	A2	A
Individual (Viability) /Financial Strength	N/A	C	C (BB+)
Support Rating	N/A	N/A	3

N/A – Not Assessed

- Short and long-term ratings assess the capacity of an organisation to make timely payments of financial obligations.

- Individual / Financial Strength ratings (which are only provided by Moody's and Fitch) are an assessment of how well the organisation can 'stand on its own feet' without the support of others. Scored from A (best) to E. The Fitch Individual ratings are being replaced by Viability ratings, which are similar and an equivalent rating has been applied.

- Support ratings (which are only provided by Fitch) assess the propensity and ability of other parties to support an organisation. Scored 1 (best) to 5.

d) **Annex E** contains an overview of a table published by the Audit Commission to summarise the rating systems used by Fitch, Moody's and Standard & Poors for long and short term debt. **Annex F** contains a summary of the Individual / Financial Strength and Support Rating.

e) From time to time the rating agencies may put an institution on either a 'positive or negative watch' which means that their credit rating is under review. Following the watch period the rating may go up or down or indeed remain unaltered. Dependent upon any revised rating an institution may then remain on, be removed from or come back onto our approved counterparty list.

f) If an institution is put on 'negative watch' by any one of the rating agencies where the current credit rating is higher than the lowest acceptable criteria for the Council, an assessment of all relevant market information will be taken, and subject to this assessment the counterparty will continue to be on the approved list, although with a shortened period for investment of no more than 1 month. The maximum deposit amount will also be reduced to £2m.

g) If an institution is put on negative watch and is on the lowest acceptable criteria for the Council, no funds will be deposited with them until any revised rating has been assessed and meets the counterparty criteria.

h) If an institution, which already has Council funds deposited with it, is put on negative watch by any of the rating agencies and is already on the lowest acceptable criteria or is downgraded to below the acceptable rating criteria, the Council will enter discussions with the counterparty to establish if the funds can be returned early, however this will be subject to an appropriate cost versus risk assessment of the specific situation.

Sovereign Rating

i) If the institution is non-UK, then the country in which it is domiciled must have a minimum Sovereign long term rating of AAA.

Guaranteed Banks with Suitable Sovereign Support

j) The Council may use banks whose ratings fall below the criteria specified above if all of the following conditions are met:

   (i) wholesale deposits in the bank are covered by a government guarantee;

   (ii) the government providing the guarantee is rated "AAA" by all three major rating agencies (Fitch, Moody's and Standard & Poors); and

   (iii) the Council's investments with the bank are limited to amounts and maturities within the terms of the stipulated guarantee.

Part Nationalised banks

k) If the UK Government has a significant stakeholding in an institution, the institution can be view as a part nationalised bank. Currently Lloyds Banking Group (including the Bank of Scotland) and Royal Bank of Scotland can be classified as Part Nationalised Banks. These institutions will be included in the Counterparty list for as long as they continue to be part nationalised or the meet the Council's minimum rating criteria in c) above.

Council's Own Banker

l) The Council's own banker (currently Bank of Scotland plc) will be maintained on the Council's counterparty list in situations where rating changes may mean this is below the above criteria. This is to allow the Council to continue to operate normal current account banking facilities, or their overnight and short-term investment facilities.

m) The Bank of Scotland plc (a subsidiary of Lloyds Banking Group) in its capacity as the Council's own banker, will be maintained on the approved counterparty list, on the basis that funds may not on any day exceed £5m. This limit is subject to any excess that arises on the banking being cleared on the next available banking day and the need to maintain sufficient funds to fulfill the automated next available banking day payments to ensure they are processed efficiently.

5.6 Country, Group and Sector Considerations

a) Due care will be taken to consider the country, group and sector exposure of the Council's investments.

Country Limits

b) In part the country selection will be chosen by the credit rating of the Sovereign state. In addition no more than **10%** will be placed with any non-UK country at any time.

Institutional Sector Limits

c) Limits will be applied to the overall amount lent out to any one sector at any one time in order to limit sector specific exposure risk, as follows:

UK Building Societies	**£25 m**
Banks	**£35 m**
UK Local Authorities	**£40 m**
UK Government Debt Management Office	**£unlimited**
UK Gilts and Treasury Bills	**£20 m**
Institutions covered by Government Guarantee	**£10 m**
Part Nationalised Banks	**£35 m**
Money Market Funds (AAA)	**£20 m**

Institutional sector limits require to be significant as local authorities tend to be cash rich at much the same time, which would make lending difficult if we did not have the potential for placing large cash sums with banks and building societies. These limits will be monitored regularly for appropriateness.

Group Limits

d) Limits will be applied to the overall amount lent out to institutions within the same group at any one time in order to limit group specific exposure risk, as follows, and subject to the parent company having a minimum AA- long term rating:

Group of Banks	**£10m**

5.7 Use of Additional Information

a) Whilst the above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, it is recognised that ratings should not be the sole determinant of the quality of an institution and that it is important to contiunally 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.

b) 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.

5.8 Individual Institution Time and Monetary Limits

a) The time and monetary limits for institutions on the Council's Counterparty List are as follows:

	Money Limit	Time Limit
UK Building Societies	£5 m	Up to 364 days
Banks	£5 m	Up to 364 days
UK Local Authorities (i)	£40 m	Up to 364 days
UK Government Debt Management Office	Unlimited	Up to 6 months
UK Gilts & Treasury Bills	£20m	Up to 364 days
Government Guaranteed Institutions	£2 m	Up to 6 months
AAA rated Money Market Funds	£5m	Up to 6 months
Part Nationalised Banks	£5 m	Up to 6 months
Council's Own Banker (ii)	£5 m	Up to 364 days, but overnight if it falls below the minimum criteria

Note:

(i) No individual limit will be applied on lending to a UK local authority, other than it must not exceed the relevant sector limit of £40m.

(ii) Further to Sections 5.5, 5.6 and 5.8 in the event that the Council's own banker's rating falls below the criteria the time limit on the money deposited will be reduced to overnight and short term (1 month or less) investment facilities.

(iii) All individual limits will be applied to an organisation subject to that amount not breaching any relevant country, sector or group limit.

b) As mentioned previously, the Treasury function manages the funds of the Council, the Pension Fund, the Common Good Funds and Trust Funds. When applying the limits set out in both paragraphs 5.6 and 5.8, these limits will apply to the cumulative investment with an institution from the Council, the Pension Fund, the Common Good Funds and Trust Funds.

5.9 The Monitoring of Investment Counterparties

a) The credit rating of counterparties will be monitored regularly. The Council receives credit rating information (changes, rating watches and rating outlooks) from Sector as and 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 Chief

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

b) The criteria for choosing counterparties set out above provide a sound approach to investment in “normal” market circumstances. Under the exceptional current market conditions, the Chief Financial Officer may temporarily restrict further investment activity to those counterparties considered of higher credit quality than the minimum criteria set out in this Strategy. These restrictions will remain in place until the Chief Financial Officer is of an opinion that the banking system has returned to “normal”. Similarly the time periods for investments may be restricted.

5.10 Types of Investments

a) For institutions on the approved counterparty list, investments will be restricted to safer instruments (such as deposits). Currently this involves the use of the DMADF and institutions with higher credit ratings than those outlined in the investment strategy or which are provided support from the Government. Investments are being maintained short term to also improve the security of investments.

b) Investments arranged via the London money market will be made through approved brokers. The current list of approved brokers comprises:

(i) ICAP Securities Limited
(ii) Sterling International Brokers Limited
(iii) Tradition (UK) Limited.

5.11 Investment Strategy

In-house funds

a) 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

b) Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 3 of 2013. Bank Rate forecasts for financial year ends (March) are:

2011/ 2012 0.50%
2012/ 2013 0.50%
2013/ 2014 1.25%
2014/ 2015 2.50%

c) There are downside risks to these forecasts (i.e. start of increases in Bank Rate is delayed even further) if economic growth remains weaker for longer than expected. However, should the pace of growth pick up more sharply than expected there could be upside risk, particularly if Bank of England inflation forecasts for two years ahead exceed the Bank of England’s 2% target rate.

d) The estimates used for the budgeted investment earnings rates for returns on investments placed for periods up to three months during each financial year for the next five years are as follows:

2012/13	0.50%
2013/14	0.50%
2014/15	1.50%
2015/16	2.00%

Investment Treasury Indicator And Limit (Treasury Indicator TI-4) - total principal funds invested for greater than 364 days.

e) 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.

f) The treasury indicator and limit proposed is: -

Maximum principal sums invested > 364 days (TI-4)			
£m	2012/13	2013/14	2014/15
Principal sums invested > 364 days	20%	20%	20%

g) For its cash flow generated balances, the Council will seek to utilise its business overnight accounts, 15 and 30 day notice accounts, money market funds and short-dated deposits (overnight to three months) in order to benefit from the compounding of interest.

5.12 Icelandic Bank Investments

a) Repayments from Heritable are expected to be complete by October 2012.

b) The Icelandic Supreme Court has confirmed the preferential creditor status of Landsbanki. Repayment will be made in a mix of pounds sterling, US Dollars, Euros and Icelandic Krona. The repayments (except for Icelandic Krona) will be converted to sterling upon receipt in the Council's bank account. Icelandic Krona conversion is subject to separate arrangements because of issues around currency controls.

5.13 Risk Benchmarking

a) A development arising from the revised Treasury Management Codes is the need for consideration and approval of security and liquidity benchmarks. Yield benchmarks are currently widely used to assess performance, however discrete security and liquidity benchmarks are new requirements and their application is more subjective in nature. Additional background to the approach taken is attached at **Annex G**.

b) These benchmarks are simple targets (not limits) and so may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is that officers will monitor the current and trend position and amend the operational strategy depending on any changes. Any breach of the benchmarks will be reported, with supporting reasons, in the Mid-Year or Annual Report.

Security

c) The Council's **maximum** security risk benchmark for the current portfolio, when compared to historic default tables, is:

0.04% historic risk of default when compared to the whole portfolio.

Liquidity

d) In respect of this area the Council seeks to maintain:

Bank Overdraft £250,000 (with the ability to increase this to £3,000,000)

e) Liquid short term deposits of at least £3,000,000 available with a week's notice.

f) Weighted Average Life benchmark is **expected to be 0.5 years** (equivalent to an weighted average life of 6 months), with a **maximum of 1.00 years**

Yield

g) Local measures of yield benchmarks are:

Investments – **Internal returns above the 7 day LIBID rate**

h) At the end of the financial year, the Chief Financial Officer will report on its investment activity as part of the Annual Treasury Report.

6 Performance Indicators

6.1 The CIPFA Code requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking.

6.2 Debt Performance Indicators

a) Average "Pool Rate" charged by the Loans Fund compared to Scottish Local Authority average Pool Rate.
Target is to be at or below the Scottish Average for 2011/12.

b) Average rate movement year on year
Target is to maintain or reduce the average borrowing rate for the Council versus 2010/11.

6.3 Investment Risk Benchmark Indicators for Security, Liquidity and Yield, as set out in paragraph 5.13:

6.4 Loan Charges:

The actual Loan Charges for 2012/13 will be at or below the Revenue Budget estimate contained in the Council's Financial Plans to be approved on 10 February 2011, which is estimated as follows:

£m	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Interest on Borrowing	11.2	10.8	11.4
Investment income	(0.1)	(0.1)	(0.1)
Capital Repayments	10.2	10.4	10.0
Total Loan Charges	**21.3**	**21.3**	**21.3**

The above budget excludes the revenue impact of funding the cost of the NHT and the lending to RSLs as these are assumed to be revenue neutral overall, and have still to be fully quantified. As information that is more detailed becomes available, this projection will be updated, if necessary.

6.5 The results of these indicators will be incorporated into in the Treasury Management Annual Report.

7 Monitoring And Reporting

7.1 In line with the CIPFA Code the following formal reporting arrangements will be adopted:

Requirement	Purpose	Decision making body	Frequency
Treasury Management Policy Statement	Reviews and Revisions	Council	As required
Treasury Management & Investment Strategy	Reporting of Annual Strategy	Council	Annually prior to start of new financial year
Treasury Management Strategy and / or Treasury Investment Strategy	Updates and revisions	Council	As appropriate
Treasury Management Mid-Year Report	Mid-Year Performance Report	Council	Annually in October/November of the current year
Treasury Management Annual Report	Annual Performance report for previous financial year	Council	Annually following the revenue outturn report to Executive
Treasury Management Monitoring Reports	Including Revenue Budget Monitoring	Executive	Revenue reported as part of the regular monitoring reports, otherwise as and when appropriate
Treasury Management Practices		Executive	As appropriate
Scrutiny of Treasury Management & Investment Strategy	Detailed scrutiny prior to annual approval by Council	Audit Committee	Annually
Scrutiny of Treasury Management Performance		Audit Committee	As appropriate

8 Treasury Management Consultants and Advisers

8.1 The Council uses Sector as its external treasury management consultants. The company provides a range of services which include:

- Technical support on treasury matters, capital finance issues and the drafting of Member reports;
- Economic and interest rate analysis;
- Debt services which includes advice on the timing of borrowing;
- Debt rescheduling advice surrounding the existing portfolio;
- Generic investment advice on interest rates, timing and investment instruments;
- Credit ratings/market information service comprising the three main credit rating agencies;

8.2 As part of the service provided, Sector meet with Council officers on a quarterly basis to review the current Treasury Management and Investment Strategies and review the service provided to the Council.

8.3 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.

8.4 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

9 Member and Officer Training

9.1 The increased Member consideration of treasury management matters and the need to ensure officers dealing with treasury management are trained and kept up to date requires a suitable training process for Members and officers. This Council will address this important issue by:

a. **Elected Members**

   (i) Working with members of the Audit Committee to identify their training needs

   (ii) Working with Sector to identify appropriate training provision for elected members

b. **Officers** dealing with treasury management matters will have the option of various levels of training including:

   (i) The CIPFA/ Treasury Management Professional Qualification

   (ii) Treasury courses run by the Council's advisers

   (iii) Attendance at CIPFA treasury management training events

   (iv) Attendance at the CIPFA Scottish Treasury Management Forum and information exchange via the Treasury Management Forum network

   (v) On the job training in line with the approved Treasury Management Practices (TMPs).

ANNEXES

ANNEX A
SUMMARY OF PRUDENTIAL AND TREASURY INDICATORS

Indicator Reference	Indicator	Page Ref.	2012/13	2013/14	2014/15
PRUDENTIAL INDICATORS					
Capital Expenditure Indicator					
PI-1	Capital Expenditure Limits	5	£28.7m	£24.3m	£24.2m
PI-2	Capital Financing Requirement (CFR)	6	£276.8m	£294.7m	£288.7m
Affordability Indicator					
PI-3	Ratio of Financing Costs to Net Revenue	7	9.59%	9.84%	10.31%
PI-4	Incremental Impact of Capital Investment Decisions on Council Tax	7	(£0.01)	(£0.01)	(£0.01)
External Debt Indicators					
PI-5	Actual Debt	8	£256.2m	£282.7m	£284.7m
PI-7a	Operational Boundary (inc. Other Long Term Liabilities)	9	£272.3m	£288.0m	£287.9m
PI-7b	Operational Boundary (exc. Other Long Term Liabilities)	9	£213.8m	£215.0m	£216.9m
PI-8a	Authorised Limit (inc. Other Long Term Liabilities)	9	£304.7m	£323.9m	£318.2m
PI-8b	Authorised Limit (exc. Other Long Term Liabilities)	9	£246.2m	£250.9m	£247.2m
Indicators of Prudence					
PI-6	(Under)/Over Net Borrowing against the CFR	8	(£42.4m)	(£21.3m)	(£21.8m)
TREASURY INDICATORS					
TI-1	Upper Limit to Fixed Interest Rates based on Net Debt	12	£273.3m	£288.0m	£287.9m
TI-2	Upper Limit to Variable Interest Rates based on Net Debt	12	£95.3m	£100.8m	£100.8m
TI-3	Maturity Structure of Fixed Interest Rate Borrowing 2012/13	12	**Lower**		**Upper**
	Under 12 months		0%		20%
	12 months to 2 years		0%		20%
	2 years to 5 years		0%		20%
	5 years to 10 years		0%		20%
	10 years and above		20%		100%
TI-4	Maximum Principal Sum invested greater than 364 days	22	20%	20%	20%

ANNEX B
Interest Rate Forecast 2011/2015

Sector's Interest Rate View	Now	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Sector's Bank Rate View	**0.50%**	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.25%	2.50%
3 Month LIBID	**0.87%**	0.70%	0.70%	0.70%	0.70%	0.70%	0.75%	0.80%	0.90%	1.20%	1.40%	1.60%	2.10%	2.40%	2.60%
6 Month LIBID	**1.16%**	1.00%	1.00%	1.00%	1.00%	1.00%	1.10%	1.20%	1.40%	1.60%	1.80%	2.00%	2.50%	2.70%	2.90%
12 Month LIBID	**1.65%**	1.50%	1.50%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.20%	2.40%	2.60%	3.10%	3.20%	3.30%
5yr PWLB Rate	**2.25%**	2.30%	2.30%	2.30%	2.30%	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	3.10%	3.30%	3.50%	3.70%
10yr PWLB Rate	**3.33%**	3.30%	3.30%	3.30%	3.40%	3.40%	3.50%	3.60%	3.70%	3.80%	4.00%	4.20%	4.40%	4.60%	4.80%
25yr PWLB Rate	**4.24%**	4.20%	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%
50yr PWLB Rate	**4.26%**	4.30%	4.30%	4.30%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%
Bank Rate															
Sector's View	**0.50%**	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.25%	2.50%
UBS	**0.50%**	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-	-	-	-	-
Capital Economics	**0.50%**	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-
5yr PWLB Rate															
Sector's View	**2.25%**	2.30%	2.30%	2.30%	2.30%	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	3.10%	3.30%	3.50%	3.70%
UBS	**2.25%**	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Capital Economics	**2.25%**	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	-	-	-	-	-
10yr PWLB Rate															
Sector's View	**3.33%**	3.30%	3.30%	3.30%	3.40%	3.40%	3.50%	3.60%	3.70%	3.80%	4.00%	4.20%	4.40%	4.60%	4.80%
UBS	**3.33%**	3.45%	3.45%	3.50%	3.60%	3.65%	-	-	-	-	-	-	-	-	-
Capital Economics	**3.33%**	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	-	-	-	-	-
25yr PWLB Rate															
Sector's View	**4.24%**	4.20%	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%
UBS	**4.24%**	4.80%	4.90%	4.90%	4.90%	4.90%	-	-	-	-	-	-	-	-	-
Capital Economics	**4.24%**	4.30%	4.30%	4.30%	4.30%	4.30%	4.30%	4.30%	4.30%	4.30%	-	-	-	-	-
50yr PWLB Rate															
Sector's View	**4.26%**	4.30%	4.30%	4.30%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%
UBS	**4.26%**	4.80%	4.95%	4.95%	5.00%	5.00%	-	-	-	-	-	-	-	-	-
Capital Economics	**4.26%**	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	-	-	-	-	-

ANNEX C
Economic Background

1 Global Economy

The outlook for the global economy remains clouded with uncertainty with the UK economy struggling to generate sustained recovery that offers solid optimistim for the outlook for 2012, or possibly even into 2013. Consumer and business confidence levels are low and with little to boost sentiment, it is not easy to see potential for a significant increase in the growth rate in the short term.

At the centre of much of the uncertainty is the ongoing **Eurozone sovereign debt crisis** which has intensified, rather than dissipated throughout 2011. The main problem has been **Greece**, where, even with an Eurozone/IMF/ECB bailout package and the imposition of austerity measures aimed at deficit reduction, the lack of progress and the ongoing deficiency in addressing the underlying lack of competitiveness of the Greek economy, has seen an escalation of their problems. These look certain to result in a default of some kind but it currently remains unresolved if this will be either “orderly” or “disorderly”. Most commentators currently view that it is now inevitable that Greece will have to exit the Eurozone in 2012.

There is also growing concern about the situation in **Italy** and the risk that contagion has not been contained. Italy is the third biggest debtor country in the world but its prospects are limited given the poor rate of economic growth over the last decade and likely difficulties in implementing the required level of fundamental reforms in the economy. The Eurozone now has a well established track record of always doing too little too late to deal with this crisis; this augurs poorly for future prospects, especially given the rising level of electoral opposition in northern EU countries to bailing out profligate southern countries.

The US economy has encouraged with some positive news around the start of 2012 but any improvement in the weak rate of growth is likely to only generate slow progress in reducing the high level of unemployment which is acting as such a dampener on the economy. With Presidential elections due in November 2012, the current administration has been hamstrung by political gridlock with the two houses split between the main parties. In quarter 3 the Federal Reserve started “Operation Twist” in an effort to re-ignite the rate of growth in the economy. However, high levels of consumer indebtedness, a moribund housing market together with stubbornly high unemployment, will continue to weigh heavily on consumer confidence and so on the abiltity to generate a healthy and consistent rate of economic growth.

Hopes for broad based recovery have, therefore, focussed on the **emerging markets** but these areas have been struggling with inflationary pressures in their previously fast growth economies. China, though, has maintained its growth pattern, despite a major thrust to tighten monetary policy during 2011 to cool inflationary pressures which are now subsiding. However, some forward looking indicators are causing concern that there may not be a soft landing ahead, which would then be a further dampener on world economic growth.

2 UK Economy

The Government’s austerity measures, aimed at getting the public sector deficit into order over the next four years, have yet to fully impact on the economy. However, coming at a time when economic growth has been weak and concerns at the risk of a technical recession (two quarters of negative growth) in 2012, it looks likely that the private sector will not make up for the negative impact of these austerity measures given the lack of an export led recovery due to the downturn in our major trading partner – the EU. The housing market, a gauge of consumer confidence, remains weak and the outlook is for house prices to be little changed for a prolonged period.

Economic Growth. GDP growth has, basically, flatlined since the election of 2010 and, worryingly, the economic forcecasts for 2012 and beyond have been revised lower on a near quarterly basis. With concerns of a potential return to recession, the Bank of England embarked on a second round of Quantitive Easing to stimulate economic activity. It appears very likely that there will be another expansion of quantitative easing in quarter 1 2012 in order to stimulate economic growth.

Unemployment. With the impact of the Government's austerity strategy resulting in steadily increasing unemployment during 2011, there are limited prospects for any improvement in 2012 given the prospects for weak growth.

Inflation and Bank Rate. For the last two years, the MPC's contention has been that high inflation was the outcome of temporary external factors and other one offs (e.g. changes in VAT); that view remains in place with CPI inflation starting quarter 1 of 2012 at 4.8%, having peaked at 5.2% in September 2011. They remain of the view that the rate will fall back to, or below, the 2% target level within the two year horizon.

AAA rating. The ratings agencies have recently reaffirmed the UK's AAA sovereign rating and have expressed satisfaction with Government policy for deficit reduction. They have, though, warned that this could be reviewed if the policy were to change, or was seen to be failing to achieve its desired outcome. This credit position has ensured that the UK government is able to fund itself at historically low levels and, with the safe haven status from Eurozone debt also drawing in external investment, the pressure on rates has been down, and looks set to remain so for some time.

3 Sector's Forward View

Economic forecasting remains troublesome with so many extermal influences weighing on the UK. There does, however, appear to be consensus among analysts that the economy remains weak and whilst there is still a broad range of views as to potential performance, they have all been downgraded throughout 2011. Key areas of uncertainty include:

- a worsening of the Eurozone debt crisis and heightened risk of the breakdown of the bloc or even of the currency itself;
- the impact of the Eurozone crisis on financial markets and the banking sector;
- the impact of the Government's austerity plan on confidence and growth and the need to rebalance the economy from services to exporting manufactured goods;
- the under-performance of the UK economy which could undermine the Government's policies that have been based upon levels of growth that inceasingly seem likely to be undershot;
- a continuation of high levels of inflation ;
- the economic performance of the UK's trading partners, in particular the EU and US, with some analysts suggesting that recession could return to both;
- stimulus packages failing to stimulate growth;
- elections due in the US, Germany and France in 2012 or 2013;
- potential for protectionism i.e. an escalation of the currency war / trade dispute between the US and China.

The overall balance of risks remains weighted to the downside. Lack of economic growth, both domestically and overseas, will impact on confidence putting upward pressure on unemployment. It will also further knock levels of demand which will bring the threat of recession back into focus.

Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries.

Given the weak outlook for economic growth, Sector sees the prospects for any interest rate changes before mid-2013 as very limited. There is potential for the start of Bank Rate increases to be even further delayed if growth disappoints.

Source: Sector Treasury Services Ltd, January 2012

Annex D

Credit and Counterparty Risk Management

Permitted Investments, Associated Controls and Limits for Scottish Borders Council, Common Good and Trust Funds and In-house Managed Pension Fund

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good & Trust Fund Limits	Pension Fund In-House Limits
Cash type instruments					
a. Deposits with the Debt Management Account Facility (UK Government) **(Very low risk)**	This is a deposit with the UK Government and as such counterparty and liquidity risk is very low, and there is no risk to value. Deposits can be between overnight and 6 months.	Little mitigating controls required. As this is a UK Government investment the monetary limit is unlimited to allow for a safe haven for investments.	£unlimited, maximum 6 months.	£unlimited, maximum 6 months.	£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.	£40m and maximum 1 year.	£5m and maximum 1 year.	£40m and maximum 1 year.
c. Money Market Funds (MMFs) **(Very low risk)**	Pooled cash investment vehicle which provides very low counterparty, liquidity and market risk. These will primarily be used as liquidity instruments.	Funds will only be used where the MMFs are Constant Net Asset Value (CNAV), and the fund has a “AAA” rated status from either Fitch, Moody’s or Standard & Poors.	£5m per fund/£20m overall	£5m per fund/£20m overall	£5m per fund/£20m overall

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good & Trust Fund Limits	Pension Fund In-House Limits
d. 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 Poors. The selection defaults to the lowest available credit rating to provide additional risk control measures. On 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.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.
e. 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 Poors. The selection defaults to the lowest available credit rating to provide additional risk control measures. On 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.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good & Trust Fund Limits	Pension Fund In-House Limits
f. UK 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.	£20m, maximum 1 year.	£5m, maximum 1 year	£20, maximum 1 year.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good & Trust Fund Limits	Pension Fund In-House Limits
Other types of investments					
g. 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.	£30m	£25m	N/A
h. 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.	£30m	£1m	N/A
i. National Housing Trust	These are loans to a Special Purpose Vehicle to allow it to purchase new homes under the NHT umbrella. These loans represent either 65% or 70% of the purchase price, the remainder being funded by the developer. The loan is redeemed after a 5 to 10 year period when the properties are sold.	Loan redemption arises when the homes are sold. Interest payments are made to the Council by the SPV from rental payments in the intervening period. Both the loan amount and associated interest payments are underwritten by Scottish Government	£4m per phase up to a maximum of £8m	N/A	N/A

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good & Trust Fund Limits	Pension Fund In-House Limits
j. Pooled Investment Vehicles	These use an investment vehicle, for long term capital growth and income returns. These are liquid assets in the sense that there is a market value, however there is a high risk of volatility in the short and medium term in relation to market values and dividend income streams.	The Common Good Investment Strategy sets out the risk/return criteria and the asset allocation for these investments. It also sets out the mechanisms for monitoring and managing the performance of the funds.	£0	All Capital Balances nominated by the Common Good & Trust Fund Working Groups as approved by Council up to a maximum of £4m	N/A

Use of External Fund Managers

It is the Council's policy to use external fund managers for part of its investment portfolio in relation to the pooled investment fund for the Common Good Fund, Trust Funds and the Scottish Borders Council Pension Fund. This Annex reflects the approved policies around the Common Good and Trust Fund Investment Strategy but specifically excludes, as allowed by the regulations, the work undertaken by External Fund Managers in relation to the Scottish Borders Council Pension Fund.

The fund managers are contractually committed to keep to the Council's approved investment strategy.

ANNEX E

Long and Short Term Credit Ratings

Audit Commission Grading#	**Fitch**		**Moody's**		**Standard and Poor's**	
	Long Term	**Short Term**	**Long Term**	**Short Term**	**Long Term**	**Short Term**
Extremely strong grade	AAA	F1+	Aaa	P-1	AAA	A-1+
Very strong grade	AA+ AA AA-	F1+ F1+ F1+	Aa1 Aa2 Aa3	P-1 P-1 P-1	AA+ AA AA-	A-1+ A-1+ A-1+
Strong grade But susceptible to adverse conditions	A+ A A-	F1+ / F1 F1 F1	A1 A2 A3	P-1 P-1 / P-2 P-1 / P-2	A+ A A	A-1+ / A-1 A-1 A-1 / A-2
Adequate Grade	BBB+ BBB BBB-	F2 F2 / F3 F3	Baa1 Baa2 Baa3	P-2 P-2 / P-3 P-3	BBB+ BBB BBB-	A-2 A-2 / A-3 A-2
Speculative Grade	BB+ BB BB-	B B B	Ba1 Ba2 Ba3	NP * NP NP	BB+ BB BB-	B-1 B-2 B-3
Very Speculative Grade	B+ B B-	B B B	Ba1 Ba2 Ba3	NP NP NP	B+ B B-	- - -
Vulnerable Grade	CCC CCC CCC CC C	C C C C C	Caa1 Caa2 Caa3 - Ca	NP NP NP NP NP	CCC+ CCC CCC- CC C	C C C C C
Defaulting Grade	D	D	C	NP	D	D

for the purpose of standardisation based on Standard and Poor's credit rating definitions.
* NP – Not Prime

Source: Audit Commission adaptation of information from Fitch, Moody's and Standard & Poor's

Shaded area donates credit ratings that are within the current policy criteria for Scottish Borders Council.

ANNEX F

Individual Strength/Support Ratings

Moody’s	Bank Financial Strength
Superior intrinsic financial strength	**A**
Strong intrinsic financial strength	**B**
Adequate intrinsic financial strength	**C**
Modest intrinsic financial strength	**D**
Very modest intrinsic financial strength	**E**

Fitch	Bank Individual (Viability) Ratings
A very strong bank	**A (aa – aaa)**
A strong bank	**B (bbb – aa-)**
An adequate bank	**C (bb+ – bbb-)**
A bank with weaknesses	**D (ccc – bb)**
A bank with very serious problems	**E (c – ccc-)**
A bank that has defaulted	**F**

Fitch	Support Ratings
A bank for which there is an extremely high probability of external support.	**1**
A bank for which there is a high probability of external support	**2**
A bank for which there is a moderate probability of support	**3**
A bank for which there is a limited probability of support	**4**
A bank for which external support, although possible, cannot be relied upon	**5**

Shaded area donates credit ratings that are within the current policy criteria for Scottish Borders Council.

Annex G

Benchmarking and Monitoring Security, Liquidity and Yield

A proposed development for Member reporting is the consideration and approval of security and liquidity benchmarks.

These benchmarks are targets and so may be breached from time to time. Any breach will be reported, with supporting reasons in the Annual Treasury Report.

Yield

These benchmarks are currently widely used to assess investment performance. Local measures of yield benchmarks are:

- Investments – **Internal returns above the 7 day LIBID rate**

Security and liquidity benchmarks are already intrinsic to the approved treasury strategy through the counterparty selection criteria and some of the prudential indicators. Proposed benchmarks for the cash type investments are below and these will form the basis of future reporting in this area. In the other investment categories appropriate benchmarks will be used where available.

Liquidity

This is defined as "having adequate, though not excessive cash resources, borrowing arrangements, overdrafts or standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives" (CIPFA Treasury Management Code of Practice). In respect of this area the Council seeks to maintain:

- Bank overdraft - £250,000 (with the ability to increase this to £3,000,000)
- Liquid short term deposits of at least £3,000,000 available with a week's notice.

The availability of liquidity and the term risk in the portfolio can be benchmarked by the monitoring of the Weighted Average Life (WAL) of the portfolio – shorter WAL would generally embody less risk. In this respect the proposed benchmark is to be used:

- **WAL benchmark is expected to be 0.5 years, with a maximum of 1.00 years**.

Security of the investments

In context of benchmarking, assessing security is a much more subjective area to assess. Security is currently evidenced by the application of minimum credit quality criteria to investment counterparties, primarily through the use of credit ratings supplied by the three main credit rating agencies (Fitch, Moody's and Standard and Poors). Whilst this approach embodies security considerations, benchmarking levels of risk is more problematic. One method to benchmark security risk is to assess the historic level of default against the minimum criteria used in the Council's investment strategy.

The table beneath shows an average of historic cumulative default rates sourced from the three main rating agencies for the last 20-30 years.

Long term rating	1 year	2 years	3 years	4 years	5 years
AAA	0.000%	0.015%	0.052%	0.103%	0.155%
AA	0.028%	0.059%	0.115%	0.174%	0.250%
A	0.077%	0.220%	0.398%	0.561%	0.741%
BBB	0.231%	0.687%	1.203%	1.767%	2.370%

The Council's minimum long term rating criteria is currently "A", meaning the average expectation of default for a one year investment in a counterparty with a "A" long term rating would be 0.077% of the total investment (e.g. for a £1m investment the average loss would be £770). This is only an average - any specific counterparty loss is likely to be higher - but these figures do act as a proxy benchmark for risk across the portfolio.

The Council's maximum security risk benchmark for the whole portfolio, when compared to these historic default tables, is:

- **0.04% historic risk of default when compared to the whole portfolio.**

These benchmarks are embodied in the criteria for selecting cash investment counterparties and these will be monitored and reported to Members in the Investment Annual Report. As this data is collated, trends and analysis will be collected and reported. Where a counterparty is not credit rated a proxy rating will be applied.

GLOSSARY OF TERMS

CIPFA	Chartered Institute of Public Finance and Accountancy
CIPFA Code	Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes (2011 Edition)
CFR	Capital Financing Requirement is the estimated the level of borrowing or financing needed to fund capital expenditure.
Consent to Borrow	Para 1 (1) of Schedule 3 of the Local Government (Scotland) Act 1975 (the 1975 Act) effectively restricts local authorities to borrowing only for capital expenditure. Under the legislation Scottish Ministers may provide consent for local authorities to borrow for expenditure not covered by this paragraph, where they are satisfied that the expenditure should be met by borrowing.
Gilts	A gilt is a UK Government liability in sterling, issued by HM Treasury and listed on the London Stock Exchange. The term “gilt” or “gilt-edged security” is a reference to the primary characteristic of gilts as an investment: their security. This is a reflection of the fact that the British Government has never failed to make interest or principal payments on gilts as they fall due.
LIBID	London Interbank Bid Rate The rate at which banks bid on Eurocurrency Deposits, being the rate at which a bank is willing to borrow from other banks.
MPC	Monetary Policy Committee
Other Long Term Liabilities	Balance sheet items such as Public Private Partnership (PPP), and leasing arrangements which already include borrowing instruments.
PPP	Private Finance Initiative
Prudential Indicators	The Prudential Code sets out a basket of indicators (the Prudential Indicators) that must be prepared and used in order to demonstrate that local authorities have fulfilled the objectives of the Prudential Code.
QE	Quantitative Easing
Treasury Indicators	These consist of a number of Treasury Management Indicators that local authorities are expected to ‘have regard’ to, to demonstrate compliance with the Treasury Management Code of Practice.

VERSION CONTROL TABLE

Version	Nature of Amendment	Date of Change	Author
1	Updated 2012 TMS doc	04/01/12	LM
2	Updated for revised Indicators	12/01/12	NC/LM
3	Final Draft for Audit Committee	19/01/12	LM
4	Final Draft for Council	31/01/12	LM

You can get this document on tape, in Braille, large print and various computer formats by contacting the address below. Lynn Mirley can also give information on other language translations as well as providing additional copies.

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