APPENDIX 1

SCOTTISH BORDERS COUNCIL

TREASURY MANAGEMENT STRATEGY
(incorporating the Annual Investment Strategy) 2013/14

Finance
Resources Department
Version 1
Approved: xx

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, estimated and actual figures.

a) **Prudential and treasury indicators and treasury stategy** (this report).
This report is the most important of the three reports and covers:

- The Capital Plans of the Council (including prudential indicators);
- The Treasury Management Strategy (how the investments and borrowings are 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 will update members with the progress of the capital position, amending prudential indicators as necessary.

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

1.3 Scrutiny

These reports are required to be adequately scrutinised by committee before being recommended to the Council. This role is undertaken by the Audit Committee.

1.4 The Treasury Management issues covered by this report include:

Capital Issues
- the capital plans and the prudential indicators.

Treasury management issues
- 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 Scottish Government Investment Regulations.

1.6 Treasury Management Consultants

The Council uses Sector 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 and will ensure that it does not only rely upon information and advice from our external service providers is not placed upon our external service providers.

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

1.7 The Treasury Management Strategy covers the treasury management activities for the Council, the Scottish Borders Council Pension Fund, the Common Good and 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 received 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 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 2013/14 – 2015/16

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 this planning cycle. The Capital Financial Plan for 2013/14 – 2022/23 includes the following capital expenditure forecasts:

Capital Expenditure (PI-1) £m	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Engineering Infrastructure	13.6	12.5	10.3	10.5	6.2
Land & Property	11.6	12.5	11.8	11.4	13.1
Business Infrastructure	2.8	1.9	2.1	5.3	5.4
Fleet	2.7	2,9	-	0.8	-
Other	0.5	1.2	0.6	0.6	0.6
Total	**31.2**	**31.0**	**24.8**	**28.6**	**25.3**

3.2 Other Long Term Liabilities

The financing need identified above in paragraph 3.1 includes other long term liabilities, such as Public Private Partnerships (PPP) and leasing arrangements which already include borrowing instruments.

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 lending to the National Housing Trust (NHT) (approved by Council 10 February 2011) and the proposed borrowing to lend to Registered Social Landlords (RSLs) (approved by Council 15 December 2011). Consent was received for the NHT borrowing, though no application has yet been made for the RSLs and the estimated amounts are as follows:

Other Relevant Expenditure £m	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
National Housing Trust (NHT)	-	2.4	1.6	-	-
Regional Social Landlords (RSLs)	-	-	10.6	1.1	0.5
Total	**-**	**2.4**	**12.2**	**1.1**	**0.5**

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	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Capital Expenditure	31.2	31.0	24.8	28.6	25.3
Other Relevant Expenditure	-	2.4	12.2	1.1	0.5
Total Expenditure	**31.2**	**33.4**	**37.0**	**29.7**	**25.8**
Financed by:					
Capital receipts	0.5	0.7	0.8	2.4	1.9
Developer Contributions	0.4	0.1	0.1	0.1	0.1
Govt. General Capital Grants	11.9	9.4	8.8	13.4	11.5
Govt. Specific Capital Grants	0.3	0.5	2.3	0.5	5.4
Other Grants & Contributions	1.3	1.4	2.4	5.0	1.2
Capital Grants (Waverley Railway)	6,2	2.4	-	-	-
CFCR	0.3	-	-	-	0.4
Plant & Vehicle Fund	2.6	2.6	-	-	-
Net financing need for the year	**7.7**	**16.3**	**22.6**	**8.3**	**5.3**

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. The CFR does not increase indefinitely, as scheduled debt amortisation (loans pool charges) broadly reduces the borrowing need in line with each assets life.

b) The CFR includes any other long term liabilities (e.g. PPP schemes, finance leases). 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 £59.9m of such schemes within the 2012/13 long term liabilities figure.

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

Capital Financing Requirement (PI-2) £m	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Total CFR (PI-2)	**257.9**	**264.1**	**276.3**	**274.6**	**285.2**
Movement in CFR represented by:					
Net financing need for the year (above)		13.9	10.4	7.2	4.8
Less scheduled debt amortisation and other financing movements		7.7	(1.8)	8.9	(5.8)
Movement in CFR		**6.2**	**12.2**	**(1.7)**	**10.6**

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:

Ratio of financing costs to net revenue stream (Prudential Indicator PI-3)

b) 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.

%	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Ratio of Financing Costs to Net Revenue Stream (PI-3)	8.59	8.85	9.16	9.13	9.23

The estimates of financing costs include current commitments and the proposals in the Financial Plans for 2013/14.

Incremental impact of capital investment decisions on council tax (Prudential Indicator PI-4)

c) This indicator identifies the revenue costs associated the operational three year capital programme detailed 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.

£	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Incremental impact of capital investment decisions on the band D council tax (PI-4)	(0.02)	0.00	0.00

The key reason for the nil impact in 2013/14 and 2014/15 is the maintenance of the revenue consequences of the loan charges cap at £21.3m within the Financial Strategy proposed for the Council.

4 Treasury Management Strategy

The capital expenditure plans set out in Section 3 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 appropriate 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 2012, with forward projections, is summarised below. The table shows the actual external borrowing, against the capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

£m	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
External Debt:					
Borrowing at 1 April		171.1	184.7	209.6	217.7
Expected change in borrowing		13.6	24.9	8.1	1.4
Borrowing at 31 March	**171.1**	**184.7**	**209.6**	**217.7**	**219.1**
Other long-term liabilities (OLTL) at 1 April		61.9	59.9	58.2	56.5
Expected change in OLTL		(2.0)	(1.7)	(1.7)	14.6
OLTL at 31 March	**61.9**	**59.9**	**58.2**	**56.5**	**71.1**
Total Actual External Debt at 31 March (Prudential Indicator PI-5)	**233.0**	**244.6**	**267.8**	**274.2**	**290.2**
Investments at 31 March	**9.5**	**7.5**	**6.5**	**6.0**	**9.0**
Net borrowing	**223.5**	**237.1**	**261.3**	**268.2**	**281.2**
CFR – the borrowing need (inc estimates of additional CFR for following 2 yrs – see 4.1 b)	**276.3**	**274.6**	**285.2**	**282.2**	**282.2**
(Under) / over borrowing (Prudential Indicator PI-6)	**(52.8)**	**(37.5)**	**(23.9)**	**(14.0)**	**(1.0)**

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 2013/14 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 no difficulties are currently envisaged for the future. This view takes into account current commitments, existing plans, and the proposals in the Financial Plans for 2012/13.

4.2 Treasury Indicators: Limits to Borrowing Activity

The Operational Boundary (Prudential Indicator PI-7)

a) This is the limit 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	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Total Operational Boundary (PI-7a)	**262.2**	**279.7**	**286.2**	**300.6**
Less: Other long term liabilities	59.9	58.2	56.5	71.1
Operational Boundary exc. Other Long Term Liabilities (PI-7b)	**202.3**	**221.5**	**229.7**	**229.5**

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

b) 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, but is not sustainable in the longer term.

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

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

Authorised Limit £m	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Total Authorised Limit (PI-8a)	**298.0**	**321.6**	**323.1**	**330.1**
Less: Other long term liabilities	59.9	58.2	56.5	71.1
Authorised Limit exc. Other Long Term Liabilities (PI-8b)	**238.1**	**263.4**	**266.6**	**259.0**

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	PWLB Borrowing Rates		
		5 year	25 year	50 year
Dec 2012	0.50	1.50	3.70	3.90
March 2013	0.50	1.50	3.80	4.00
June 2013	0.50	1.50	3.80	4.00
Sept 2013	0.50	1.60	3.80	4.00
Dec 2013	0.50	1.60	3.80	4.00
March 2014	0.50	1.70	3.90	4.10
June 2014	0.50	1.70	3.90	4.10
Sept 2014	0.50	1.80	4.00	4.20
Dec 2014	0.50	2.00	4.10	4.30
March 2015	0.75	2.20	4.30	4.50
June 2015	1.00	2.30	4.40	4.60
Sept 2015	1.25	2.50	4.60	4.80
Dec 2015	1.50	2.70	4.80	5.00
March 2016	1.75	2.90	5.00	5.20

Forecast as at 12 Nov 2012

b) The economic recovery in the UK since 2008 has been the worst with the slowest recovery in recent history, although the economy returned to positive growth in the third quarter of 2012. Growth prospects are weak and consumer spending, the usual driving force of recovery, is likely to remain under pressure due to consumers focusing on repayment of personal debt, inflation eroding disposable income, general malaise about the economy and employment fears.

c) The primary drivers of the UK economy are likely to remain external. 40% of UK exports go to the Euozone so the difficulties in this area are likely to continue to hinder UK growth. The US, the main world economy, faces similar debt problems to the UK, but urgently needs to resolve the fiscal cliff now that the the Presidential elections are out of the way. The resulting US fiscal tightening and continuing Eurozone problems will depress UK growth and is likely to see the UK deficit reduction plans slip.

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

- The Eurozone sovereign debt difficulties provide a clear indication of high 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 2013/14 and beyond.
- Borrowing interest rates continue to be attractive and may remain relatively low for some time. The timing of any borrowing will need to be monitored carefully.
- There will remain a cost of carry – any borrowing undertaken that results in an increase in investments will incur a revenue loss between borrowing costs and investment returns.

e) **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. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded by external loan debt as the 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 relatively high. Over the medium term there is an anticipated reduction in capital support from central government and the Council's aim is to ensure 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 2013/14 treasury operations. The Chief Financial Officer will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

- *if it was felt that there was a significant risk of a sharp FALL in long and short term rates,* (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.

- *if it was felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast,* perhaps arising from 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.

Treasury Management Limits on Activity

d) 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 covers a maximum limit for borrowing exposure to fixed interest rates, based on the debt position net of investments.

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

This identifies a maximum limit for borrowing exposure to 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 treasury indicators and limits:

£m	2013/14	2014/15	2015/16
Interest rate Exposures			
	Upper	**Upper**	**Upper**
Limits on fixed interest rates based on net debt (TI-1)	279.7	286.2	300.6
Limits on variable interest rates based on net debt (TI-2)	97.9	100.2	105.2
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%
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) 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.

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:

- the benefits of borrowing in advance,
- the investment risks created by the existence of investments at the same time as additional borrowing being outstanding, and
- 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:

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

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 2013/14

5.1 Investment Objectives and Policy

a) The Council's investment policy has regard to the Scottish Government's Investment (Scotland) Regulations (and accompanying Finance Circular) and the 2011 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second and then return.

b) In accordance with the above guidance from the Scottish Government and CIPFA, and in order to minimise the risk to investments, the Council has below (see 5.3 below) clearly stipulated the minimum acceptable credit quality of counterparties for inclusion on the lending list. The creditworthiness methodology used to create the counterparty list fully accounts for the ratings, watches and outlooks published by all three ratings agencies. Using the Sector ratings service, potential counterparty ratings are monitored on a real time basis with knowledge of any changes notified electronically as the agencies notify modifications.

c) Further, the Council's officers recognise that ratings should not be the sole determinant of the quality of an institution and that it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To this end the Council will engage with its advisors to maintain a monitor on market pricing such as "credit default swaps" and overlay that information on top of the credit ratings. This is fully intetgrated into the credit methodology provided by the advisors, Sector, in producing its colour codings which show the varying degrees of suggested creditworthiness.

d) 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.

e) The aim of the strategy is to generate a list of highly creditworthy counterparties which will also enable diversification and thus avoidance of concentration risk. The intention of the strategy is to provide security of investment and minimisation of risk.

f) 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.

g) 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.

h) The Council will ensure 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.

5.2 Council Permitted Investments

a) The Local Government Investments (Scotland) Regulations 2010 requires the Council to give approval for 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.

5.3 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 Counterparty Creditworthiness Rating Methodology. 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) This Council will apply the creditworthiness service provided by Sector in 2013/14. 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 (summaries of which are contained in **Annexes E** and **F**). 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.

c) 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*:*

Creditworthiness Colour Banding	Maximum Investment Duration
Purple	2 years
Blue (only applies to nationalised or semi nationalised UK Banks)	1 year
Orange	1 year
Red	6 months
Green	3 months
No colour	not to be used

d) The Sector creditworthiness service uses a wider array of information than just primary ratings and by using a risk weighted scoring system, does not give undue weight to just one agency's ratings. Typically however the minimum credit ratings criteria the Council use would be as follows:

	Standard & Poors	Moodys	Fitch
Short-Term Debt Rating	A-1	P-1	F1
Long-Term Debt Rating	A-	A3	A-
Viability /Financial Strength	N/A	C	a-
Support Rating	N/A	N/A	1

e) There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but the counterparty 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.

f) 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 government support for banks and the credit ratings of that supporting government.

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

c) 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

d) These institutions must either be UK Local Authorities or UK Incorporated Institutions, UK Banks and Building Societies 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).

e) If the UK Government has a significant stakeholding in an institution, the institution can be viewed as a part nationalised bank. Currently Lloyds Banking Group (including the Bank of Scotland) and Royal Bank of Scotland can be classified as Semi-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 above.

f) 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**

g) 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

h) 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 appearing on Sector's creditworthiness list:

Group of Banks **£10m**

Council's Own Banker

i) The Council's own banker (currently Bank of Scotland plc, although the Council's banking transactional services are being tendered at the time of writing) 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. However in the event that the rating does change below the criteria officers will review the situation very carefully and identify any appropriate action required to manage the risk that this change creates for the Council.

j) 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 fulfil the automated next available banking day payments to ensure they are processed efficiently.

5.5 Individual Institution Monetary Limits

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

	Money Limit
UK Building Societies	£5m
Banks	£5m
UK Local Authorities (i)	£40m
UK Government Debt Management Office	Unlimited
UK Gilts & Treasury Bills	£20m
Government Guaranteed Institutions	£2m
AAA rated Money Market Funds	£5m
Part Nationalised Banks	£5m
Council's Own Banker (ii)	£5m

(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 5.4 and 5.5, 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) The time limits for investment duration with institutions are established in paragraph 5.3 f).

c) 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 the table above, these limits will apply to the cumulative investment with an institution from the Council, the Pension Fund, the Common Good Funds and Trust Funds.

5.6 The Monitoring of Investment Counterparties

a) All credit ratings will be monitored on a weekly basis. The Council is alerted to changes to ratings of all three agencies through its use of the Sector 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 weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

b) If an institution, which already has Council funds deposited with it, 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. This however this will be subject to an appropriate cost versus risk assessment of the specific situation.

c) 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 duration of investments may be restricted.

5.7 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 money market funds, the DMADF and institutions with higher credit ratings than those outlined in the investment strategy or those in which the Government has a significant shareholding. 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:

- ICAP Securities Limited
- Sterling International Brokers Limited
- Tradition (UK) Limited

5.8 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 4 of 2014. Bank Rate forecasts for financial year ends (March) as at November 2012 are:

2012/2013	0.50%
2013/2014	0.50%
2014/2015	0.75%
2015/2016	1.75%

c) There are downside risks to these forecasts (i.e. start of increase to the Bank Rate may be 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 suggested 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	0.60%
2015/16	1.50%

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 positive cash balances, the Council will seek to utilise its business overnight accounts, short term (< 1 month) notice accounts, money market funds and short-dated deposits (overnight to three months) in order to benefit from the compounding of interest.

5.9 Risk Benchmarking

These benchmarks are simple guides to maximum risk, so they may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmarks are that officers will monitor the current and trend position and amend the operational strategy to manage risk as conditions change. Any breach of the benchmarks will be reported, with supporting reasons in the mid-year or Annual Report.

a) Security

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.

b) Liquidity

In respect of this area the Council seeks to maintain:

- Bank Overdraft: £250,000
- Liquid short term deposits of at least £3,000,000 available with a week's notice.
- 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**

c) Yield

Local measures of yield benchmarks are:

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

d) 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

(i) 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 2012/13.

(ii) **Average borrowing rate movement year on year**

Target is to maintain or reduce the average borrowing rate for the Council versus 2012/13.

6.3 **Investment Risk Benchmark Indicators** for Security, Liquidity and Yield, as set out in paragraph 5.9.

6.4 Loan Charges

a) Loan Charges for 2013/14 are expected to be at or below the Revenue Budget estimate contained in the Council's Financial Plans to be approved on 7 February 2013, which are estimated as follows:

£m	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Interest on Borrowing	11.0	11.4	10.5
Investment income	(0.1)	(0.1)	(0.1)
Capital Repayments	10.4	10.0	10.9
Total Loan Charges	**21.3**	**21.3**	**21.3**

b) 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 it does not only rely upon information and advice from 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**
- Working with members of the Audit Committee to identify their training needs
- 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:
- Treasury courses run by the Council's advisers
- Attendance at CIPFA treasury management training events
- Attendance at the CIPFA Scottish Treasury Management Forum and information exchange via the Treasury Management Forum network
- 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.	2013/14	2014/15	2015/16
PRUDENTIAL INDICATORS					
Capital Expenditure Indicator					
PI-1	Capital Expenditure Limits	5	£24.8m	£28.6m	£25.3m
PI-2	Capital Financing Requirement (CFR)	6	£276.3m	£274.6m	£285.2m
Affordability Indicator					
PI-3	Ratio of Financing Costs to Net Revenue	7	9.16%	9.13%	9.23%
PI-4	Incremental Impact of Capital Investment Decisions on Council Tax	7	0.02	0.00	0.00
External Debt Indicators					
PI-5	Actual Debt	8	£267.8m	£274.2m	£290.2m
PI-7a	Operational Boundary (inc. Other Long Term Liabilities)	9	£279.7m	£286.2m	£300.6m
PI-7b	Operational Boundary (exc. Other Long Term Liabilities)	9	£221.5m	£229.7m	£229.5m
PI-8a	Authorised Limit (inc. Other Long Term Liabilities)	9	£321.6m	£323.1m	£330.1m
PI-8b	Authorised Limit (exc. Other Long Term Liabilities)	9	£263.4m	£266.6m	£259.0m
Indicators of Prudence					
PI-6	(Under)/Over Net Borrowing against the CFR	8	(£23.9m)	(£14.0m)	(£1.0)m
TREASURY INDICATORS					
TI-1	Upper Limit to Fixed Interest Rates based on Net Debt	12	£279.7m	£286.2m	£300.6m
TI-2	Upper Limit to Variable Interest Rates based on Net Debt	12	£97.9m	£100.2m	£105.2m
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	20	20%	20%	20%

ANNEX B
Interest Rate Forecast 2012/2016 (as at 12 Nov 12)

Sector's Interest Rate View	Now	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
Sector's Bank Rate View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%
3 Month LIBID	0.40%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.60%	0.60%	0.70%	0.80%	1.10%	1.40%	1.70%	1.90%
6 Month LIBID	0.56%	0.70%	0.70%	0.70%	0.70%	0.70%	0.70%	0.80%	0.90%	1.00%	1.10%	1.30%	1.60%	1.90%	2.20%
12 Month LIBID	0.92%	1.00%	1.00%	1.00%	1.00%	1.00%	1.10%	1.10%	1.20%	1.30%	1.30%	1.50%	1.80%	2.10%	2.40%
5yr PWLB Rate	1.66%	1.50%	1.50%	1.50%	1.60%	1.60%	1.70%	1.70%	1.80%	2.00%	2.20%	2.30%	2.50%	2.70%	2.90%
10yr PWLB Rate	2.64%	2.50%	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%	3.30%	3.50%	3.70%	3.90%
25yr PWLB Rate	3.88%	3.70%	3.80%	3.80%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.30%	4.40%	4.60%	4.80%	5.00%
50yr PWLB Rate	4.04%	3.90%	4.00%	4.00%	4.00%	4.00%	4.10%	4.10%	4.20%	4.30%	4.50%	4.60%	4.80%	5.00%	5.20%
Bank Rate															
Sector's View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%
UBS	0.50%	0.50%	0.50%	0.50%	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	1.66%	1.50%	1.50%	1.50%	1.60%	1.60%	1.70%	1.70%	1.80%	2.00%	2.20%	2.30%	2.50%	2.70%	2.90%
UBS	1.66%	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Capital Economics	1.66%	1.30%	1.30%	1.30%	1.30%	1.30%	1.30%	1.30%	1.50%	1.60%	-	-	-	-	-
10yr PWLB Rate															
Sector's View	2.64%	2.50%	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%	3.30%	3.50%	3.70%	3.90%
UBS	2.64%	2.80%	3.00%	3.10%	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	-	-	-	-	-
Capital Economics	2.64%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	-	-	-	-	-
25yr PWLB Rate															
Sector's View	3.88%	3.70%	3.80%	3.80%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.30%	4.40%	4.60%	4.80%	5.00%
UBS	3.88%	4.00%	4.20%	4.30%	4.40%	4.50%	4.50%	4.50%	4.50%	4.50%	-	-	-	-	-
Capital Economics	3.88%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	-	-	-	-	-
50yr PWLB Rate															
Sector's View	4.04%	3.90%	4.00%	4.00%	4.00%	4.00%	4.10%	4.10%	4.20%	4.30%	4.50%	4.60%	4.80%	5.00%	5.20%
UBS	4.04%	4.10%	4.30%	4.40%	4.50%	4.60%	4.60%	4.60%	4.60%	4.60%	-	-	-	-	-
Capital Economics	4.04%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	-	-	-	-	-

ANNEX C
Economic Background

Global Economy

The Eurozone debt crisis has continued to cast a pall over the world economy and has depressed growth in most countries. This has impacted the UK economy which is creating a major headwind for recovery in 2013. Quarter 2 of 2012 was the third quarter of contraction in the economy. This recession is the worst with the slowest recovery of any of the five recessions since 1930.

The **Eurozone sovereign debt crisis** has abated somewhat following the ECB's pledge to buy unlimited amounts of bonds of countries which ask for a bailout. The immediate target for this statement was Spain which continues to prevaricate on making such a request (for a national bailout) and so surrendering its national sovereignty to IMF supervision. However, the situation in Greece is heading towards a crunch point as the Eurozone imminently faces up to having to relax the time frame for Greece reducing its total debt level below 120% of GDP and providing yet more financial support to enable it to do that. Many commentators still view a Greek exit from the Euro as inevitable as total debt now looks likely to reach 190% of GDP i.e. unsustainably high, unless the Eurozone were to accept a major write down of Greek debt. The possibility of a write down has now been raised by the German Chancellor, but not until 2014-15, and provided the Greek annual budget is in balance.

Sentiment in financial markets has improved considerably since this ECB action and recent Eurozone renewed commitment to support Greece and to keep the Eurozone intact. However, the foundations to this "solution" to the Eurozone debt crisis are still weak and events could easily conspire to put this into reverse.

The US economy has only been able to manage weak growth in 2012 despite huge efforts by the Federal Reserve to stimulate the economy by liberal amounts of quantitative easing (QE) combined with a commitment to a continuation of ultra low interest rates into 2015. Unemployment levels have been slowly reducing but against a background of a fall in the numbers of those available for work. The fiscal cliff facing the President at the start of 2013 has been a major dampener discouraging business from spending on investment and increasing employment more significantly in case there is a sharp contraction in the economy in the pipeline. However, the housing market does look as if it has, at long last, reached the bottom and house prices are now on the up.

Hopes for a broad based recovery have, therefore, focused on the **emerging markets**. However, there are increasing concerns over flashing warning signs in various parts of the Chinese economy that indicate it could be in risk of heading for a hard landing rather than a gradual slow down.

The UK economy

The Government's austerity measures, aimed at getting the public sector deficit into order, have now had to be extended in the autumn statement over a longer period than the original four years. Achieving this new extended time frame will still be dependent on the UK economy returning to a reasonable pace of growth towards the end of this period. It was important for the Government to retain investor confidence in UK gilts so there was little room for it to change course other than to move back the timeframe.

Currently, the UK is enjoying a major financial benefit from some of the lowest sovereign borrowing costs in the world as the UK is seen as a safe haven from Eurozone debt. There is, though, little evidence that consumer confidence levels are recovering or that the manufacturing sector is picking up. On the positive side, growth in the services sector rebounded in Q3 and banks have made huge progress since 2008 in shrinking their balance sheets to more manageable levels and also in reducing their dependency on wholesale funding. However, availability of credit remains tight in the economy and the Funding for Lending scheme, which started in August 2012, has not yet had time to make a significant impact. Finally, the housing market remains tepid and the outlook is for house prices to be little changed for a prolonged period.

Economic Growth. Economic growth has basically flat-lined since the election of 2010 and, worryingly, the economic forecasts for 2012 and beyond were revised substantially lower in the Bank of England Inflation quarterly report for August 2012 and were then further lowered in the November Report. Quantitative Easing (QE) was increased again by £50bn in July 2012 to a total of £375bn. Many forecasters are expecting the MPC to vote for a further round of QE to stimulate economic activity regardless of any near-term optimism. The announcement in November 2012 that £35bn will be transferred from the Bank of England's Asset Purchase Facility to the Treasury (representing coupon payments to the Bank by the Treasury on gilts held by the Bank) is also effectively a further addition of QE.

Unemployment. The Government's austerity strategy has resulted in a substantial reduction in employment in the public sector. Despite this, total employment has increased to the highest level for four years as over one million jobs have been created in the private sector in the last two years.

Inflation and Bank Rate. Inflation has fallen sharply during 2012 from a peak of 5.2% in September 2011 to 2.2% in September 2012. However, inflation increased back to 2.7% in October though it is expected to fall back to reach the 2% target level within the two year horizon.

AAA rating. The UK continues to enjoy an AAA sovereign rating. However, the credit rating agencies will be carefully monitoring the rate of growth in the economy as a disappointing performance in that area could lead to a major derailment of the plans to contain the growth in the total amount of Government debt over the next few years. Moody's has stated that it will review the UK's Aaa rating at the start of 2013.

Sector's forward view

Economic forecasting remains difficult with so many external influences weighing on the UK. There does however appear to be consensus among analysts that the economy remains relatively fragile and whilst there is still a broad range of views as to potential performance, expectations have all been downgraded during 2012. Key areas of uncertainty include:

- the potential for the Eurozone to withdraw support for Greece at some point if the Greek government was unable to eliminate the annual budget deficit and the costs of further support were to be viewed as being prohibitive, so causing a worsening of the Eurozone debt crisis and heightened risk of the breakdown of the bloc or even of the currency itself;

- inter government agreement on how to deal with the overall Eurozone debt crisis could fragment; 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 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 are unlikely to be achieved;

- the risk of the UK's main trading partners, in particular the EU and US, falling into recession ;

- stimulus packages failing to stimulate growth;

- elections due in Germany in 2013;

- potential for protectionism i.e. an escalation of the currency war / trade dispute between the US and China.

- the potential for action to curtail the Iranian nuclear programme

- the situation in Syria deteriorating and impacting other countries in the Middle East

The focus of so many consumers, corporates and banks on reducing their borrowings, rather than spending, will continue to act as a major headwind to a return to robust growth in western economies.

Given the weak outlook for economic growth, Sector sees the prospects for any changes in Bank Rate before 2015 as very limited. There is potential for the start of Bank Rate increases to be even further delayed if growth disappoints. 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. The interest rate forecast in this report represents a balance of downside and upside risks. The downside risks have already been commented on. However, there are specific identifiable upside risks to PWLB rates and gilt yields, and especially to longer term rates and yields as follows:

- UK inflation being significantly higher than in the wider EU and US causing an increase in the inflation premium in gilt yields.
- Reversal of QE: this could initially occur by allowing gilts held by the Bank to mature without reinvesting in new purchases, later followed by outright sale of gilts currently held.
- Reversal of Sterling's safe haven status on an improvement in financial stresses in the Eurozone.
- Investors reverse de-risking by moving money from government bonds into shares in anticipation of a return to worldwide economic growth.
- The possibility of a UK credit rating downgrade (Moody's has stated that it will review the UK's Aaa rating at the start of 2013).

Source: Sector Treasury Services Ltd, December 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, 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 realizable 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 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

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	**aa – aaa**
A strong bank	**bbb – aa-**
An adequate bank	**bb+ – bbb-**
A bank with weaknesses	**ccc – bb**
A bank with very serious problems	**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**

Annex G

Benchmarking and Monitoring Security, Liquidity and Yield

The consideration and approval of security and liquidity benchmarks are also part of Member reporting. 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. Benchmarks for the cash type investments are below. In the other investment categories appropriate benchmarks will be used where available.

Liquidity
This is defined as an organisation "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
- Liquid short term deposits of at least £3,000,000 available with a week's notice.

The availability of liquidity 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 the 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 Sector's Creditworthiness Policy. 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 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 Annual Treasury Management Report. As this data is collated, trends and analysis will be collected and reported.

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	Public-Private Partnership.
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
1.0	Updated TMS	14/12/12	NC
2.0	Updated for Creditworthiness Policy	4/1/13	LM
3.0	Updated Post Audit Committee 14 January 2013	17/1/13	LM
4.0	Final RSL figure updates	21/1/13	NC

You can get this document on tape, in Braille, large print and various computer formats by contacting the address below.

Contact us at Kirsty Robb, Treasury & Capital Manager, Council HQ, Newtown St Boswells

01835 825016, treasuryteam@scotborders.gov.uk