**APPENDIX 1**

# SCOTTISH BORDERS COUNCIL

# TREASURY MANAGEMENT STRATEGY
## (incorporating the Annual Investment Strategy)
## 2019/20

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# 1 Purpose and Scope

**1.1** The Council is currently 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) **Treasury Management Strategy 2019/20** (this report).
This report is the most important of the three reports and covers:

- The capital plans of the Council (including prudential indicators);
- A policy for the statutory repayment of debt, (how residual capital expenditure is charged to revenue over time);
- The treasury management strategy (how the investments and borrowings are organised), including treasury indicators, and
- A permitted investment strategy (investment options and limits applied).

b) **Mid Year Treasury Management Report** – This is primarily a progress report and will update members on the capital position, amending prudential indicators as necessary, and whether any policies require revision.

c) **Annual Treasury Report** – This is a backward looking review document and provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.

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

**1.3** The treasury management issues covered by this report are:

**Capital Issues**
- the capital expenditure plans and the associated prudential indicators
- the loan fund repayment policy

**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

**1.4** These elements cover the requirements of the Local Government in Scotland Act 2003, the CIFPA Prudential Code (the Prudential Code), the CIPFA Treasury Management Code (the Code) and Scottish Government loans fund repayment regulations and investment regulations.

**1.5** The increased Member consideration of treasury management matters and the need to ensure that 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 and Scrutiny Committee to identify their training needs
- Working with Link Asset Services 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 exchanged via the Treasury Management Forum network
- On the job training in line with the approved Treasury Management Practices (TMPs).

## 1.6 Treasury Management Consultants

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

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

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

**1.7** The Treasury Management Strategy covers the treasury management activities for the Council (including any subsidiary organisations), the cash managed by the Council on behalf of the Scottish Borders Council Pension Fund, the Common Good and Trust Funds.

# 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. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return.

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

**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 both the Prudential and Treasury Codes. 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. The Treasury Management Strategy therefore forms an integral part of the Council's overall Financial Strategy covering both its revenue and capital budgets.

**2.4** The contribution the treasury management function makes to the authority is critical, as the balance of debt and investment operations ensure liquidity or the ability to meet spending commitments as they fall due, either on day-to-day revenue or for larger capital projects. The treasury operations will see a balance of the interest costs of debt and the investment income arising from cash deposits affecting the available budget. Since cash balances generally result from reserves and balances, it is paramount to ensure adequate security of the sums invested, as a loss of principal will in effect result in a loss to the General Fund Balance.

**2.5** CIPFA defines treasury management as:

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

**2.6** Revised reporting is required for the 2019/20 reporting cycle due to revisions of the the CIPFA Prudential Code and the CIPFA Treasury Management Code. The primary reporting changes include the introduction of a capital strategy, to provide a longer-term focus to the capital plans, and greater reporting requirements surrounding any commercial activity if that is going to be undertaken. The capital strategy is being reported separately.

# 3 The Capital Prudential Indicators 2018/19 – 2023/24

The Council's Financial Strategy sets out financial resource and management parameters within which it will deliver its Corporate Vision and Priorities. The Financial Strategy brings together various elements of financial policy and strategy, including the Treasury Management Strategy, and establishes the financial planning framework for the Council in terms of Revenue Expenditure and Capital Investment. The output from this framework is the Council's Financial Plan, approved annually in February, presenting the financial proposals for delivering its services and objectives.

The Financial Strategy establishes that the Financial Principles underpinning the planning for the Council's future service delivery are to:

(i) Raise the funds required by the Council to meet approved service levels in the most effective manner;
(ii) Manage the effective deployment of those funds in line with the Council's corporate objectives and priorities; and
(iii) Provide stability in resource planning and service delivery as expressed through Corporate and Business Plans and the Revenue and Capital Financial Plan.

In order to adhere to these Principles, the Financial Strategy states that the Council will adopt Financial Objectives to:

***"ensure capital borrowing is within prudential borrowing limits and sustainable in the longer term. In this regard it is important to recognise the capital investment decisions taken now have long term borrowing implications and these have the potential to place a significant burden on future tax payers".***

The draft revenue budget sets loans charges associated with capital borrowing over the next 5 years at £20.3m in 2019/20, rising to £20.5m in 2020/21.

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

## 3.1 Capital Expenditure (Prudential Indicator PI-1)

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 2019/20 – 2028/29 includes the following capital expenditure forecasts for the first five years. 2018/19 projected outturn figures are also shown:

| Capital Expenditure (PI-1) £m | Estimate | | | | | |
|---|---|---|---|---|---|---|
| | 2018/19 | 2019/20 | 2020/21 | 2021/22 | 2022/23 | 2023/24 |
| Assets & Infrastructure | 41.2 | 23.1 | 35.2 | 34.2 | 28.3 | 16.8 |
| Other Corporate Services | 2.8 | 3.6 | 1.6 | 1.0 | 1.8 | 1.5 |
| Children & Young People | 13.2 | 6.8 | 10.3 | 10.8 | 9.5 | 9.0 |
| Culture & Sport | 1.7 | 1.2 | 1.0 | 3.0 | 1.6 | 0.7 |
| Economic Regeneration | 4.3 | 9.3 | 5.6 | 7.2 | 4.3 | 4.1 |
| Housing Strategy & Services | 0.2 | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 |
| Social Care Infrastructure | 0.0 | 3.7 | 5.7 | 2.5 | 0.3 | 0.3 |
| Emergency & Unplanned Schemes | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 |
| **Total** | **63.7** | **48.4** | **60.1** | **59.4** | **46.4** | **33.2** |

It should be noted that expenditure associated with the construction of the proposed Jedburgh inter-generational school campus is not included in the above as it is funded as a 'Design, Build, Fund & Maintain (DBFM) model and therefore out-with the Councils capital programme.

### 3.2 Other Relevant Expenditure

The Council anticipates to have additional expenditure which, for the purposes of the Treasury and Prudential Indicators, will be treated as capital expenditure. This expenditure relates to initiatives where the Council has applied, or is planning to apply, for a Consent to Borrow from the Scottish Government. The key area not included in paragraph 3.1 is borrowing to lend in respect of an affordable house building programme in partnership with the Scottish Futures Trust (Bridge Homes LLP). The estimated amounts are as follows:

| **Other Relevant Expenditure £m** | **Estimate** | | | | | |
|---|---|---|---|---|---|---|
| | **2018/19** | **2019/20** | **2020/21** | **2021/22** | **2022/23** | **2023/24** |
| Bridge Homes LLP (Affordable house building programme) | 0.4 | - | - | - | - | - |

### 3.3 Capital Financing Assumptions

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.

| **Capital Expenditure £m** | **Estimate** | | | | | |
|---|---|---|---|---|---|---|
| | **2018/19** | **2019/20** | **2020/21** | **2021/22** | **2022/23** | **2023/24** |
| Capital Expenditure – per plan | 63.7 | 48.4 | 60.1 | 59.4 | 46.4 | 33.2 |
| Other Relevant Expenditure | 0.4 | - | - | - | - | - |
| **Total Expenditure** | 64.1 | 48.4 | 60.1 | 59.4 | 46.4 | 33.2 |
| **Financed by:** | | | | | | |
| Capital receipts | 1.2 | 1.8 | 2.5 | 0.3 | 0.4 | - |
| CFCR | 1.0 | - | - | - | - | - |
| Developer Contributions | 0.2 | 3.0 | 0.5 | 0.1 | 0.1 | 0.1 |
| Govt. General Capital Grants | 14.4 | 16.7 | 15.4 | 15.4 | 15.4 | 15.4 |
| Govt. Specific Capital Grants | 9.6 | 8.1 | 14.3 | 15.4 | 8.3 | 0.8 |
| Other Grants & Contributions | 5.4 | 1.6 | 2.2 | 2.9 | 0.5 | - |
| Plant & Vehicle / Infrastructure Fund | 2.8 | 2.4 | 2.0 | 2.2 | 2.4 | 2.4 |
| **Net financing need for the year** | **29.5** | **14.8** | **23.2** | **23.1** | **19.3** | **14.5** |

### 3.4 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 indebtedness and so its underlying borrowing need. Any capital expenditure identified above, which has not immediately been paid for through a revenue or capital resource, will increase the CFR. The CFR does not increase indefinitely, as prudent annual repayments from revenue need to be made which reflect the useful life of capital assets financed by borrowing.

b) The CFR includes any other long term liabilities (e.g. PPP schemes, finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility by the PPP lease provider and so the Council is not required to separately borrow for these schemes. The Council has £70.4m of liabilities relating to such schemes within the 2018/19 long term liabilities figure. The CFR increases by a further £34.0m in 2020/21 as a result of the Jedburgh campus mentioned above.

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

| Capital Financing Requirement (PI-2) £m | Actual | Estimate | | | | | |
|---|---|---|---|---|---|---|---|
| | 17/18 | 18/19 | 19/20 | 20/21 | 21/22 | 22/23 | 23/24 |
| **Total CFR (PI-2) *** | **306.9** | **324.6** | **328.0** | **373.8** | **384.4** | **390.2** | **390.6** |
| **Movement in CFR represented by:** | | | | | | | |
| Net financing need for the year (above) | | 29.5 | 14.8 | 23.2 | 23.1 | 19.3 | 14.5 |
| Less scheduled debt amortisation and other financing movements | | (11.8) | (11.4) | 22.6 | (12.5) | (13.9) | (14.1) |
| **Movement in CFR** | | **17.7** | **3.4** | **45.8** | **10.6** | **5.8** | **0.4** |

* *The CFR for this calculation includes capital expenditure to 31 March of each financial year.*

The figures for 202/21 include £34m for Jedburgh Campus which is funded via PPP scheme and not capital borrowing requirement.

d) A key aspect of the regulatory and professional guidance is that elected members are aware of the size and scope of any commercial activity in relation to the authority's overall financial position. The capital expenditure figures shown in 3.1, 3.2 and 3.3, and the details above, demonstrate the scope of this activity and, by approving these figures, consider the scale proportionate to the Authority's remaining activity.

## 3.5 Statutory Repayment of Loans Fund Advances

a) The Council is required to set out its policy for the statutory repayment of loans fund advances prior to the start of the financial year. The repayment of loans fund advances ensures that the Council makes a prudent provision each year to pay off an element of the accumulated loans fund advances made in previous financial years.

b) A variety of options are provided to Councils so long as a prudent provision is made each year. The Council is recommended to approve the following policy on the repayment of loans fund advances:-

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

For loans fund advances made after 1 April 2016, the policy for the repayment of loans advances will be the:-

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

The annuity rate applied to the loans fund repayments was based on historic interest rates and is currently 3.97%. However, under regulation 14 (2) of SSI 2016 No 123, the Council has reviewed and re-assessed the historic annuity rate to ensure that it is a prudent application.

# 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 relevant professional Codes, so that sufficient cash is available to meet this service activity and the Council's capital strategy. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

## 4.1 Current Portfolio Position

a) The overall treasury management portfolio as at 31 March 2018 and for the position as at 31 December 2018 are shown below for both borrowing and investments.

| TREASURY PORTFOLIO | | | | |
|---|---|---|---|---|
| **Treasury investments** | actual **31.3.18** £000 | actual **31.3.18** % | current **31.12.18** £000 | current **31.12.18** % |
| banks | 8,045 | 74% | 14,880 | 94% |
| DMADF (H.M.Treasury) | 0 | 0% | 0 | 0% |
| money market funds | 2,780 | 26% | 1,020 | 6% |
| third party loans | 200 | 2% | 200 | 1% |
| **Total managed in house** | **10,825** | **100%** | **15,900** | **100%** |
| **Total managed externally** | **0** | **0%** | **0** | **0%** |
| **Total treasury investments** | **10,825** | **100%** | **15,900** | **100%** |
| Treasury external borrowing | | | | |
| local authorities | 5,000 | 2% | 0 | 0% |
| third party loans | 631 | 0% | 300 | 0% |
| PWLB | 152,919 | 75% | 159,631 | 82% |
| LOBOs | 44,170 | 22% | 34,868 | 18% |
| **Total external borrowing** | **202,720** | **100%** | **194,799** | **100%** |
| **Net treasury investments / (borrowing)** | **-191,895** | **0** | **-178,899** | **0** |

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

| **as at 31 March £m** | **Estimate** | | | | |
|---|---|---|---|---|---|
| | **2018/19** | **2019/20** | **2020/21** | **2021/22** | **2022/23** |
| **Borrowing** | 205.0 | 212.0 | 225.0 | 248.5 | 259.5 |
| **Other Long Term Liabilities** | 70.4 | 67.3 | 97.7 | 93.6 | 89.4 |
| **Total Gross Borrowing (Prudential Indicator PI-5)** | **275.4** | **279.3** | **322.7** | **342.1** | **348.9** |
| **CFR – the borrowing need *** | **324.6** | **328.0** | **373.8** | **384.4** | **390.2** |
| **(Under) / Over Borrowing (Prudential Indicator PI-6)** | **(49.2)** | **(48.7)** | **(51.1)** | **(42.3)** | **(41.3)** |

** The CFR for this calculation includes the current and two future years projected capital expenditure see 4.1b)*

c) Within the range of prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well-defined limits. One of these (PI-6) is that the Council needs to ensure that its gross debt figure (shown 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 2019/20 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue or speculative purposes.

d) The Council has complied with this prudential indicator in the current year and no difficulties are currently envisaged for the long term future. This view takes into account current commitments, existing plans, and the proposals in the Financial Plans for 2019/20.

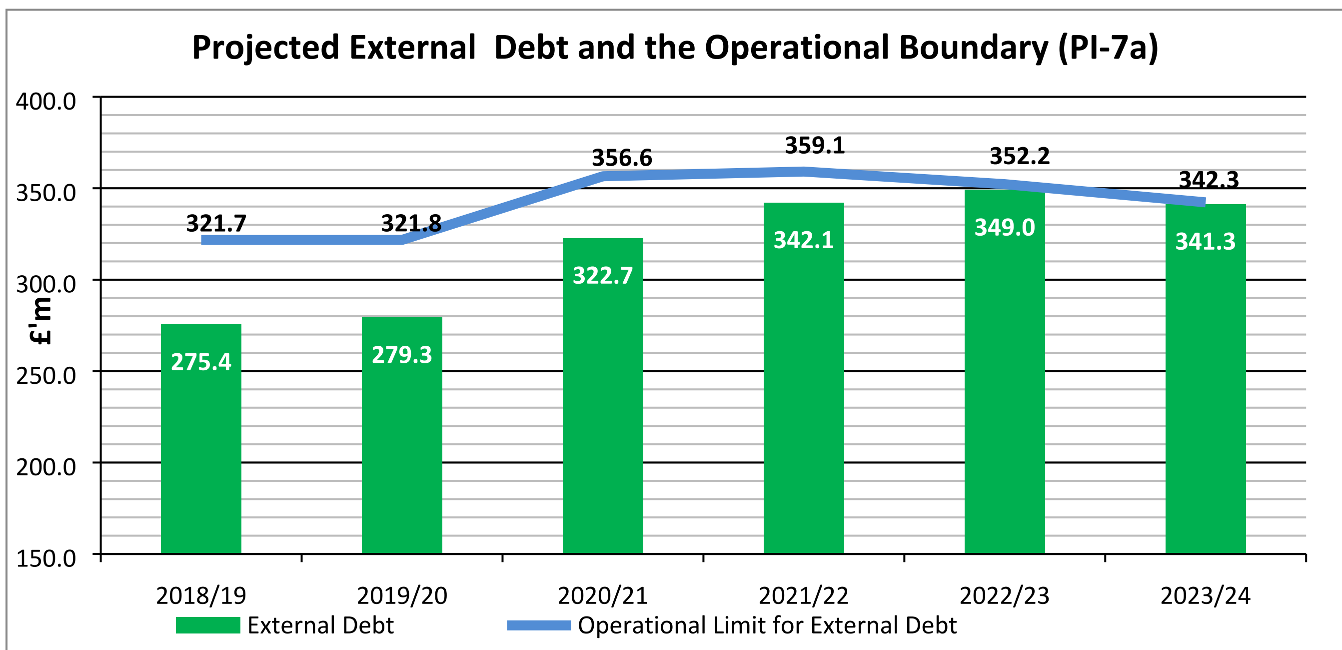
## 4.2 Treasury Indicators: Limits to Borrowing Activity

### 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 debt and the ability to fund under-borrowing by other cash resources.

| Operational boundary £m | Estimate | | | | | |
|---|---|---|---|---|---|---|
| | 2018/19 | 2019/20 | 2020/21 | 2021/22 | 2022/23 | 2023/24 |
| **Total Operational Boundary (PI-7a)** | **321.7** | **321.8** | **356.6** | **359.1** | **352.2** | **342.3** |
| Less: Other long term liabilities | (70.4) | (67.2) | (97.7) | (93.6) | (89.4) | (85.3) |
| **Operational Boundary exc. Other Long Term Liabilities (PI-7b)** | **251.3** | **254.6** | **258.9** | **265.5** | **262.8** | **257.0** |

b) The following chart shows how the current and projected Operational Borrowing limit compare with the anticipated levels of actual debt.




### The Authorised Limit for External Debt (Prudential Indicator PI-8)

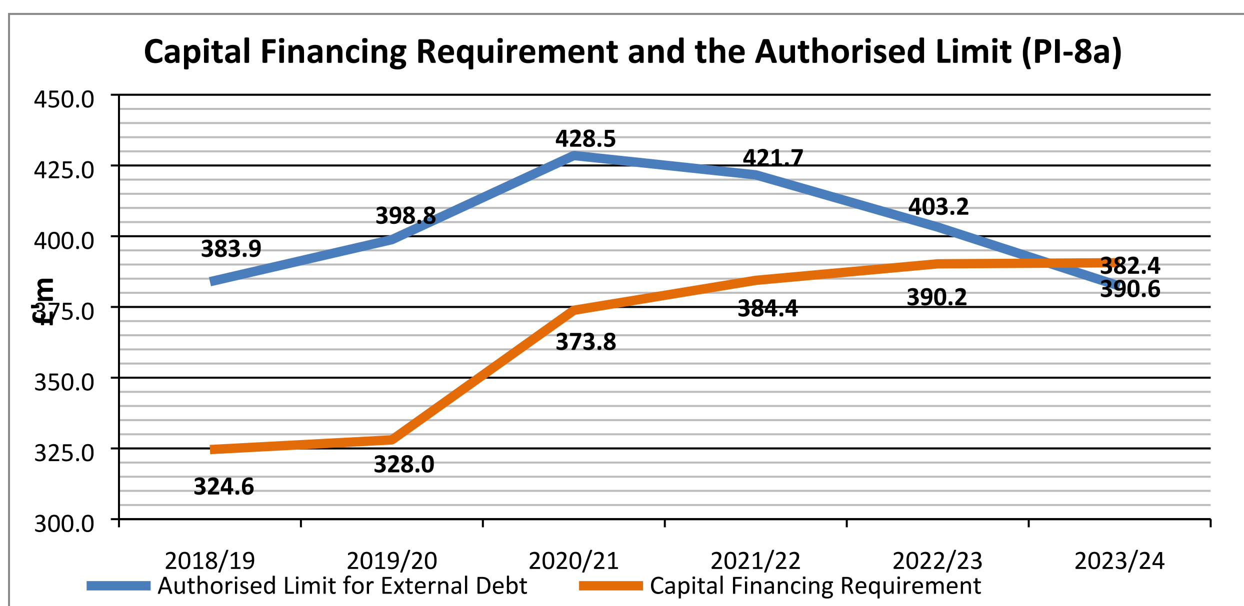
c) A further key prudential indicator represents a control on the maximum level of borrowing. This represents a legal limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external borrowing which, while not desired, could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

d) 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.

e) The Council is asked to approve the following authorised limit:

| Authorised Limit £m | Estimate | | | | | |
|---|---|---|---|---|---|---|
| | 2018/19 | 2019/20 | 2020/21 | 2021/22 | 2022/23 | 2023/24 |
| **Total Authorised Limit (PI-8a)** | **383.9** | **398.8** | **428.5** | **421.7** | **403.2** | **382.4** |
| Less: Other long term liabilities | (70.4) | (67.3) | (97.7) | (93.6) | (89.4) | (85.3) |
| **Authorised Limit exc. Other Long-Term Liabilities (PI-8b)** | **313.5** | **331.5** | **330.8** | **328.1** | **313.8** | **297.1** |

f) The chart on the below shows how the current and projected Capital Financing Requirement compares the Authorised Limit for External Debt




## 4.3 Prospects for Interest Rates

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

| Link Asset Services Interest Rate View | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Jun-21 | Sep-21 | Dec-21 | Mar-22 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Bank Rate View | 0.75% | 1.00% | 1.00% | 1.00% | 1.25% | 1.25% | 1.25% | 1.50% | 1.50% | 1.75% | 1.75% | 1.75% | 2.00% |
| 3 Month LIBID | 0.90% | 1.00% | 1.10% | 1.20% | 1.30% | 1.40% | 1.50% | 1.50% | 1.60% | 1.70% | 1.80% | 1.90% | 2.00% |
| 6 Month LIBID | 1.00% | 1.20% | 1.30% | 1.40% | 1.50% | 1.60% | 1.70% | 1.70% | 1.80% | 1.90% | 2.00% | 2.10% | 2.20% |
| 12 Month LIBID | 1.20% | 1.30% | 1.40% | 1.50% | 1.60% | 1.70% | 1.80% | 1.90% | 2.00% | 2.10% | 2.20% | 2.30% | 2.40% |
| 5yr PWLB Rate | 2.10% | 2.20% | 2.20% | 2.30% | 2.30% | 2.40% | 2.50% | 2.50% | 2.60% | 2.60% | 2.70% | 2.80% | 2.80% |
| 10yr PWLB Rate | 2.50% | 2.60% | 2.60% | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.00% | 3.10% | 3.10% | 3.20% | 3.20% |
| 25yr PWLB Rate | 2.90% | 3.00% | 3.10% | 3.10% | 3.20% | 3.30% | 3.30% | 3.40% | 3.40% | 3.50% | 3.50% | 3.60% | 3.60% |
| 50yr PWLB Rate | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.10% | 3.10% | 3.20% | 3.20% | 3.30% | 3.30% | 3.40% | 3.40% |

b) The flow of generally positive economic statistics after the quarter ended 30 June meant that it came as no surprise that the MPC came to a decision on 2 August to make the first increase in Bank Rate above 0.5% since the financial crash, from 0.5% to 0.75%. Growth became increasingly strong during 2018 until slowing significantly during the last quarter. At their November quarterly Inflation Report meeting, the MPC left Bank Rate unchanged, but expressed some concern at the Chancellor's fiscal stimulus in his Budget, which could increase inflationary pressures. However, it is unlikely that the MPC would increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. On a major assumption that Parliament and the EU agree a Brexit deal in the first quarter of 2019, then the next increase in Bank Rate is forecast to be in May 2019, followed by increases in February and November 2020, before ending up at 2.0% in February 2022.

c) The overall longer run future trend is for gilt yields, and consequently PWLB rates, to rise, albeit gently. However, over about the last 25 years, we have been through a period of falling bond yields as inflation subsided to, and then stabilised at, much lower levels than before, and supported by central banks implementing substantial quantitative easing purchases of government and other debt after the financial crash of 2008. Quantitative easing, conversely, also caused a rise in equity values as investors searched for higher returns and purchased riskier assets. In 2016, we saw the start of a reversal of this trend with a sharp rise in bond yields after the US Presidential election in November 2016, with yields then rising further as a result of the big increase in the US government deficit aimed at stimulating even stronger economic growth. That policy change also created concerns around a significant rise in inflationary pressures in an economy which was already running at remarkably low levels of unemployment. Unsurprisingly, the Fed has continued on its series of robust responses to combat its perception of rising inflationary pressures by repeatedly increasing the Fed rate to reach 2.25 – 2.50% in December 2018. It has also continued its policy of not fully reinvesting proceeds from bonds that it holds as a result of quantitative easing, when they mature. We therefore saw US 10 year bond Treasury yields rise above 3.2% during October 2018 and also investors causing a sharp fall in equity prices as they sold out of holding riskier assets. However, by early January 2019, US 10 year bond yields had fallen back considerably on fears that the Fed was being too aggressive in raising interest rates and was going to cause a recession. Equity prices have been very volatile on alternating good and bad news during this period.

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

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

f) Investment returns are likely to remain low during 2019/20 but to be on a gently rising trend over the next few years;

- Borrowing interest rates have been volatile so far in 2018-19 and while they were on a rising trend during the first half of the year, they have backtracked since then until early January. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in the future when authorities may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt.

- There will remain a cost of carry, (the difference between higher borrowing costs and lower investment returns), to any new long-term borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost.

g) **Annex C** contains a more comprehensive Economic Background narrative from Link Asset Services.

## 4.4 Borrowing Strategy

**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 with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is still an issue to be considered.

**b)** Against this background and the risks within the economic forecast, caution will be adopted with the 2019/20 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 an acceleration in the rate of increase in central rates in the USA and UK, an increase in world economic activity, or a sudden increase in inflation risks, then the portfolio position will be re-appraised. Most likely, fixed rate funding will be drawn whilst interest rates are lower than they are projected to be in the next few years.

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

## 4.5 Policy on borrowing in advance of need

**a)** Borrowing in advance of need 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.

**b)** 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.

**c)** 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.

**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 risks created by additional levels of borrowing and investment, 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

## 5.1 Investment Objectives and Policy

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

b) The Council's primary investment objectives are as follows, in order of importance:
   (i) The safeguarding or **security** of the re-payment of principal and interest of investments on a timely basis;
   (ii) The **liquidity** of its investments;
   (iii) The **returns on investments** that can be realised.

The Council will therefore aim to achieve the optimum return on its investments corresponding 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.

c) Minimum acceptable credit criteria are applied in order to generate a list of highly creditworthy counterparties. This also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the short term and long-term ratings.

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

e) 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.

f) This authority has defined the list of types of investment instruments that are permitted investments authorised for use in appendix D. Appendix F expands on the risks involved in each type of investment and the mitigating controls.

g) All investments will be denominated in **sterling.**

h) As a result of the change in accounting standards for 2018/19 under **IFRS 9,** this authority will consider the implications of investment instruments which could result in an adverse movement in the value of the amount invested and resultant charges at the end of the year to the General Fund. (This area is currently under review by LASAAC and the Scottish Government. Members will be updated when there is further news.)

i) This authority will also pursue **value for money** in treasury management and will monitor the yield from investment income against appropriate benchmarks for investment performance, (see paragraph 5.6). Regular monitoring of investment performance will be carried out during the year.

## 5.2 Council Permitted Investments

The proposed criteria for permitted investments are shown in annex D approval.

## 5.3 Creditworthiness Policy

a) This Council applies the creditworthiness service provided by Link Asset Services. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating

agencies - Fitch, Moody's and Standard and Poor's. The credit ratings of counterparties are supplemented with the following overlays:

- credit watches and credit outlooks from credit rating agencies
- Credit Default Swaps (CDS) spreads to give early warning of likely changes in credit ratings
- sovereign ratings to select counterparties from only the most creditworthy countries

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

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

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

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

**e)** All credit ratings will be monitored on a real time basis. The Council is alerted to changes to ratings of all three agencies through its use of a creditworthiness service provided by Link Asset Services.

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

**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 sovereign support for banks and the credit ratings of that supporting government.

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

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

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

## 5.4 Country and Sector Considerations

a) Due care will be taken to consider the country 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) 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) 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** |

These limits will be monitored regularly for appropriateness.

### Group Limits

g) 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 Link Asset Services' creditworthiness list:

| | |
|---|---|
| **Group of Banks** | **£10m** |

### Council's Own Banker

**h)** The Council's own banker (Bank of Scotland – part of Lloyds) 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 and overnight and short-term investment facilities. However, in the event that the rating does change below the criteria, officers will review the situation carefully and identify any appropriate action required to manage the risk that this change creates for the Council.

## 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 |
| 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 rating of the Council's own banker falls below the criteria, the time limit on money deposited with the bank will be reduced to an overnight basis.

**b)** As mentioned earlier, the treasury function manages the funds of the Council, any subsidiary organisations, the Pension Fund and the Common Good 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 and the Common Good Funds and Trust Funds.

## 5.6 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 the minimum permissible rating outlined in the investment strategy, as well as the Council's own bank.

**b)** Where appropriate, investments will be made through approved brokers. The current list of approved brokers comprises:

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

## 5.7 Investment Strategy and bank rate projections

### 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). Greater returns are usually obtainable by investing for longer periods. While most cash balances are required in order to manage the ups and downs of cash flow, where cash sums can be identified that could be invested for longer periods, the value to be obtained from longer term investments will be carefully assessed.

- If it is thought that Bank Rate is likely to rise significantly within the time horizon being considered, then consideration will be given to keeping most investments as being short term or variable.

- Conversely, if it is thought that Bank Rate is likely to fall within that time period, consideration will be given to locking in higher rates currently obtainable, for longer periods.

### Investment returns expectations

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

| | |
|---|---|
| 2018/2019 | 0.50% |
| 2019/2020 | 0.75% |
| 2020/2021 | 1.00% |
| 2021/2022 | 1.25% |

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

| | |
|---|---|
| 2018/2019 | 0.40% |
| 2019/2020 | 0.60% |
| 2020/2021 | 0.90% |
| 2021/2022 | 1.25% |

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

### Investment Treasury Indicator and Limit (Treasury Indicator TI-5)

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

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

| Maximum principal sums invested for longer than 365 days (TI-4) | | | | | |
|---|---|---|---|---|---|
| £m | 2017/18 | 2018/19 | 2019/20 | 2020/21 | 2021/22 |
| Principal sums invested for longer than 365 days | 20% | 20% | 20% | 20% | 20% |

f) For positive cash balances and in order to maintain liquidity, the Council will seek to use overnight investment accounts, short term (< 1 month) notice accounts, money market funds and short-dated

deposits (overnight to three months).

## 5.8 Investment 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 benchmark is 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 2018/19.

(ii) Average borrowing rate movement year on year

Target is to maintain or reduce the average borrowing rate for the Council versus 2018/19.

**6.3** **Investment Risk Benchmark Indicators** for Security, Liquidity and Yield, as set out in paragraph 5.8.

## 6.4 Loan Charges

**a)** Loan Charges for 2018/19 are expected to be at or below the Revenue Budget estimate contained in the Council's Financial Plans to be approved in March 2019, which are estimated as follows:

| £m | 2019/20 | 2020/21 | 2021/22 | 2022/23 | 2023/24 |
|---|---|---|---|---|---|
| Interest on Borrowing | 12.1 | 11.9 | 11.4 | 11.1 | 10.5 |
| Investment income | (0.2) | (0.2) | (0.1) | (0.1) | (0.1) |
| Capital Repayments | 8.5 | 9.4 | 9.9 | 10.4 | 11.0 |
| **Total Loan Charges *** | **20.4** | **21.1** | **21.2** | **21.4** | **21.4** |

**The Loan Charges exclude the capital element of PPP repayments.*

**b)** The above budget excludes the revenue impact of funding the cost of the NHT and the lending to RSLs and lending in respect of the Council-led house building programme with the Scottish Futures Trust, as these are assumed to be revenue neutral overall.

**6.5** The indicators, based on actual performance for the year, will be included in the Treasury Management Annual Report for 2019/20.

# ANNEXES

# ANNEX A
# SUMMARY OF PRUDENTIAL AND TREASURY INDICATORS

| Indicator Ref. | Indicator | Page Ref. | 2018/19 | 2019/20 | 2020/21 | 2021/22 | 2022/23 |
|---|---|---|---|---|---|---|---|
| **PRUDENTIAL INDICATORS** | | | | | | | |
| **Capital Expenditure Indicator** | | | | | | | |
| PI-1 | Capital Expenditure Limits (£m) | 6 | 63.7 | 48.4 | 60.1 | 59.4 | 46.4 |
| PI-2 | Capital Financing Requirement (CFR) (£m) | 8 | 324.6 | 328.0 | 373.8 | 384.4 | 390.2 |
| **Affordability Indicator** | | | | | | | |
| PI-3 | Ratio of Financing Costs to Net Revenue (inc. PPP repayment costs) | 23 | 9.8% | 9.4% | 9.7% | 10.3% | 10.5% |
| PI-4 | Incremental (Saving)/Cost Impact of Capital Investment Decisions on Council Tax | 23 | £(0.01) | £0.00 | £0.00 | £0.00 | £0.00 |
| **External Debt Indicators** | | | | | | | |
| PI-5 | Actual Debt (£m) | 9 | 275.4 | 279.3 | 322.7 | 342.1 | 348.9 |
| PI-7a | Operational Boundary (inc. Other Long Term Liabilities) (£m) | 10 | 321.7 | 321.8 | 356.6 | 359.1 | 352.2 |
| PI-7b | Operational Boundary (exc. Other Long Term Liabilities) (£m) | 10 | 251.3 | 254.6 | 258.9 | 265.5 | 262.8 |
| PI-8a | Authorised Limit (inc. Other Long Term Liabilities) (£m) | 11 | 383.9 | 398.8 | 428.5 | 421.7 | 403.2 |
| PI-8b | Authorised Limit (exc. Other Long Term Liabilities) (£m) | 11 | 313.5 | 331.5 | 330.8 | 328.1 | 313.8 |
| **Indicators of Prudence** | | | | | | | |
| PI-6 | (Under)/Over Gross Borrowing against the CFR (£m) | 9 | (49.2) | (48.7) | (51.1) | (42.3) | (41.3) |
| **TREASURY INDICATORS** | | | | | | | |
| TI-1 | Upper Limit to Fixed Interest Rates based on Net Debt (£m) | 24 | 321.7 | 321.8 | 356.6 | 359.1 | 352.2 |
| TI-2 | Upper Limit to Variable Interest Rates based on Net Debt (£m) | 24 | 112.6 | 112.6 | 124.8 | 125.7 | 123.3 |
| TI-3 | Maturity Structure of Fixed Interest Rate Borrowing 2019/20 | 24 | **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 365 days | 18 | 20% | 20% | 20% | 20% | 20% |

Further 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)

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.

| % | Actual | Estimate | | | | |
|---|---|---|---|---|---|---|
| | 17/18 | 18/19 | 19/20 | 20/21 | 21/22 | 22/23 |
| **Ratio of Financing Costs to Net Revenue Stream (PI-3)** *(inc. PPP repayment costs)* | 9.0% | 9.8% | 9.4% | 9.7% | 10.3% | 10.5% |

The estimates of financing costs include current commitments and the proposals in the Financial Plans for 2019/20. The movements in the above ratio from 2019/20 onwards reflect a real-time reduction in overall financial resources available to the Council.

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

This indicator identifies the revenue costs associated with 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.

| £ | Estimate | | | | |
|---|---|---|---|---|---|
| | 2019/20 | 2020/21 | 2021/22 | 2022/23 | 2023/24 |
| **Incremental (Saving)/Cost Impact of Capital Investment Decisions on the Band D Council Tax (PI-4)** | £0.00 | £0.00 | £0.00 | £0.00 | £(0.01) |

### 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 identifies 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 | 2018/19 | 2019/20 | 2020/21 | 2022/23 | 2023/24 |
|---|---|---|---|---|---|
| **Interest rate exposures** | | | | | |
| | **Upper** | **Upper** | **Upper** | **Upper** | **Upper** |
| **Limits on fixed interest rates based on net debt (TI-1)** | 321.7 | 321.8 | 356.6 | 359.1 | 352.2 |
| **Limits on variable interest rates based on net debt (TI-2)** | 112.6 | 112.6 | 124.8 | 125.7 | 123.3 |
| **Maturity Structure of fixed interest rate borrowing 2019/20 (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% | |

## ANNEX B: INTEREST RATE FORECASTS 2019-22

**[PWLB rates and forecast shown below have taken into account the 20 basis point certainty rate reduction effective as of the 1st November 2012.]**

| Link Asset Services Interest Rate View | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Jun-21 | Sep-21 | Dec-21 | Mar-22 |
| Bank Rate View | 0.75% | 1.00% | 1.00% | 1.00% | 1.25% | 1.25% | 1.25% | 1.50% | 1.50% | 1.75% | 1.75% | 1.75% | 2.00% |
| 3 Month LIBID | 0.90% | 1.00% | 1.10% | 1.20% | 1.30% | 1.40% | 1.50% | 1.50% | 1.60% | 1.70% | 1.80% | 1.90% | 2.00% |
| 6 Month LIBID | 1.00% | 1.20% | 1.30% | 1.40% | 1.50% | 1.60% | 1.70% | 1.70% | 1.80% | 1.90% | 2.00% | 2.10% | 2.20% |
| 12 Month LIBID | 1.20% | 1.30% | 1.40% | 1.50% | 1.60% | 1.70% | 1.80% | 1.90% | 2.00% | 2.10% | 2.20% | 2.30% | 2.40% |
| 5yr PWLB Rate | 2.10% | 2.20% | 2.20% | 2.30% | 2.30% | 2.40% | 2.50% | 2.50% | 2.60% | 2.60% | 2.70% | 2.80% | 2.80% |
| 10yr PWLB Rate | 2.50% | 2.60% | 2.60% | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.00% | 3.10% | 3.10% | 3.20% | 3.20% |
| 25yr PWLB Rate | 2.90% | 3.00% | 3.10% | 3.10% | 3.20% | 3.30% | 3.30% | 3.40% | 3.40% | 3.50% | 3.50% | 3.60% | 3.60% |
| 50yr PWLB Rate | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.10% | 3.10% | 3.20% | 3.20% | 3.30% | 3.30% | 3.40% | 3.40% |
| **Bank Rate** | | | | | | | | | | | | | |
| Link Asset Services | 0.75% | 1.00% | 1.00% | 1.00% | 1.25% | 1.25% | 1.25% | 1.50% | 1.50% | 1.75% | 1.75% | 1.75% | 2.00% |
| Capital Economics | 0.75% | 1.00% | 1.25% | 1.50% | 1.70% | 1.75% | 2.00% | 2.00% | - | - | - | - | - |
| **5yr PWLB Rate** | | | | | | | | | | | | | |
| Link Asset Services | 2.10% | 2.20% | 2.20% | 2.30% | 2.30% | 2.40% | 2.50% | 2.50% | 2.60% | 2.60% | 2.70% | 2.80% | 2.80% |
| Capital Economics | 2.03% | 2.15% | 2.40% | 2.65% | 2.70% | 2.75% | 2.80% | 2.85% | - | - | - | - | - |
| **10yr PWLB Rate** | | | | | | | | | | | | | |
| Link Asset Services | 2.50% | 2.60% | 2.60% | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.00% | 3.10% | 3.10% | 3.20% | 3.20% |
| Capital Economics | 2.43% | 2.55% | 2.80% | 3.05% | 3.05% | 3.05% | 3.05% | 3.05% | - | - | - | - | - |
| **25yr PWLB Rate** | | | | | | | | | | | | | |
| Link Asset Services | 2.90% | 3.00% | 3.10% | 3.10% | 3.20% | 3.30% | 3.30% | 3.40% | 3.40% | 3.50% | 3.50% | 3.60% | 3.60% |
| Capital Economics | 2.96% | 3.08% | 3.33% | 3.58% | 3.53% | 3.48% | 3.43% | 3.38% | - | - | - | - | - |
| **50yr PWLB Rate** | | | | | | | | | | | | | |
| Link Asset Services | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.10% | 3.10% | 3.20% | 3.20% | 3.30% | 3.30% | 3.40% | 3.40% |
| Capital Economics | 2.78% | 2.90% | 3.15% | 3.40% | 3.40% | 3.40% | 3.40% | 3.40% | - | - | - | - | - |

***Source: Link Asset Services, January 2019***

# ANNEX C
# Economic Background

**GLOBAL OUTLOOK. World growth** has been doing reasonably well, aided by strong growth in the US. However, US growth is likely to fall back in 2019 and, together with weakening economic activity in China and the eurozone, overall world growth is likely to weaken.

**Inflation** has been weak during 2018 but, at long last, unemployment falling to remarkably low levels in the US and UK has led to an acceleration of wage inflation. The US Fed has therefore increased rates nine times and the Bank of England twice. However, the ECB is unlikely to start raising rates until late in 2019 at the earliest.

**KEY RISKS - central bank monetary policy measures**
Looking back on nearly ten years since the financial crash of 2008 when liquidity suddenly dried up in financial markets, it can be assessed that central banks' monetary policy measures to counter the sharp world recession were successful. The key monetary policy measures they used were a combination of lowering central interest rates and flooding financial markets with liquidity, particularly through unconventional means such as quantitative easing (QE), where central banks bought large amounts of central government debt and smaller sums of other debt.

**The key issue now** is that period of stimulating economic recovery and warding off the threat of deflation, is coming towards its close. A new period is well advanced in the US, and started more recently in the UK, of reversing those measures i.e. by raising central rates and, (for the US), reducing central banks' holdings of government and other debt. These measures are now required in order to stop the trend of a reduction in spare capacity in the economy and of unemployment falling to such low levels, that the re-emergence of inflation is viewed as a major risk. It is, therefore, crucial that central banks get their timing right and do not cause shocks to market expectations that could destabilise financial markets. In particular, a key risk is that because QE-driven purchases of bonds drove up the price of government debt, and therefore caused a sharp drop in income yields, this also encouraged investors into a search for yield and into investing in riskier assets such as equities. Consequently, prices in both bond and equity markets rose to historically high valuation levels simultaneously. This meant that both asset categories were exposed to the risk of a sharp downward correction and we did, indeed, see a sharp fall in equity values in the last quarter of 2018. It is important, therefore, that central banks only gradually unwind their holdings of bonds in order to prevent destabilising the financial markets. It is also likely that the timeframe for central banks unwinding their holdings of QE debt purchases will be over several years. They need to balance their timing to neither squash economic recovery, by taking too rapid and too strong action, or, conversely, let inflation run away by taking action that was too slow and/or too weak. **The potential for central banks to get this timing and strength of action wrong are now key risks.** At the time of writing, (early January 2019), financial markets are very concerned that the Fed is being too aggressive with its policy for raising interest rates and is likely to cause a recession in the US economy.

The world economy also needs to adjust to a sharp change in **liquidity creation** over the last five years where the US has moved from boosting liquidity by QE purchases, to reducing its holdings of debt (currently about $50bn per month). In addition, the European Central Bank ended its QE purchases in December 2018.

**UK.** The flow of positive economic statistics since the end of the first quarter of 2018 has shown that pessimism was overdone about the poor growth in quarter 1 when adverse weather caused a temporary downward blip. Quarter 1 at 0.1% growth in GDP was followed by a return to 0.4% in quarter 2 and by a strong performance in quarter 3 of +0.6%. However, growth in quarter 4 is expected to weaken significantly.

At their November quarterly Inflation Report meeting, the MPC repeated their well-worn phrase that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary of contractionary), than before the crash; indeed they gave a figure for this of around 2.5% in ten years' time, but declined to give a medium term

forecast. However, with so much uncertainty around Brexit, they warned that the next move could be up or down, even if there was a disorderly Brexit. While it would be expected that Bank Rate could be cut if there was a significant fall in GDP growth as a result of a disorderly Brexit, so as to provide a stimulus to growth, they warned they could also *raise* Bank Rate in the same scenario if there was a boost to inflation from a devaluation of sterling, increases in import prices and more expensive goods produced in the UK replacing cheaper goods previously imported, and so on. In addition, the Chancellor could potentially provide fiscal stimulus to support economic growth, though at the cost of increasing the budget deficit above currently projected levels.

It is unlikely that the MPC would increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. Getting parliamentary approval for a Brexit agreement on both sides of the Channel will take well into spring 2019. However, in view of the hawkish stance of the MPC at their November meeting, the next increase in Bank Rate is now forecast to be in May 2019, (on the assumption that a Brexit deal is agreed by both the UK and the EU). The following increases are then forecast to be in February and November 2020 before ending up at 2.0% in February 2022.

**Inflation.** The Consumer Price Index (CPI) measure of inflation has been falling from a peak of 3.1% in November 2017 to 2.1% in December 2018. In the November Bank of England quarterly Inflation Report, inflation was forecast to still be marginally above its 2% inflation target two years ahead, (at about 2.1%), given a scenario of minimal increases in Bank Rate.

As for the **labour market** figures in October**,** unemployment at 4.1% was marginally above a 43 year low of 4% on the Independent Labour Organisation measure. A combination of job vacancies hitting an all-time high, together with negligible growth in total employment numbers, indicates that employers are now having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to 3.3%, (3 month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates less CPI inflation), earnings are currently growing by about 1.2%, the highest level since 2009. This increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This tends to confirm that the MPC was right to start on a cautious increase in Bank Rate in August as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy.

In the **political arena**, the Brexit deal put forward by the Conservative minority government was defeated on 15 January. It is unclear at the time of writing, how this situation will move forward. However, our central position is that Prime Minister May's government will endure, despite various setbacks, along the route to reaching an orderly Brexit though the risks are increasing that it may not be possible to get full agreement by the UK and EU before 29 March 2019, in which case this withdrawal date is likely to be pushed back to a new date. If, however, the UK faces a general election in the next 12 months, this could result in a potential loosening of monetary and fiscal policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

**USA.** President Trump's massive easing of fiscal policy is fuelling a (temporary) boost in consumption which has generated an upturn in the rate of strong growth which rose from 2.2% (annualised rate) in quarter 1 to 4.2% in quarter 2 and 3.5%, (3.0% y/y), in quarter 3, but also an upturn in inflationary pressures. The strong growth in employment numbers and the reduction in the unemployment rate to 3.9%, near to a recent 49 year low, has fed through to an upturn in wage inflation which hit 3.2% in November. However, CPI inflation overall fell to 2.2% in November and looks to be on a falling trend to drop below the Fed's target of 2% during 2019. The Fed has continued on its series of increases in interest rates with another 0.25% increase in December to between 2.25% and 2.50%, this being the fifth increase in 2018 and the ninth in this cycle. However, they did also reduce their forecast for further increases from three to two. This latest increase compounded investor fears that the Fed is over doing the speed and level of increases in rates and that it is going to cause a US recession as a result. There is also much evidence in previous monetary policy cycles of the Fed's series of increases doing exactly that. Consequently, we have seen stock markets around the world falling under the weight of fears around the Fed's actions, the trade war between the US and China and an expectation that world growth will slow.

The tariff war between the US and China has been generating a lot of heat during 2018, but it is not expected that the current level of actual action would have much in the way of a significant effect on US or world growth. However, there is a risk of escalation if an agreement is not reached soon between the US and China.

**Eurozone.** Growth was 0.4% in quarters 1 and 2 but fell back to 0.2% in quarter 3, though this was probably just a temporary dip. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of its manufacturing exports e.g. cars. For that reason, although growth is still expected to be in the region of nearly 2% for 2018, the horizon is less clear than it seemed just a short while ago. Having halved its quantitative easing purchases of debt in October 2018 to €15bn per month, the European Central Bank ended all further purchases in December 2018. The ECB is forecasting inflation to be a little below its 2% top limit through the next three years so it may find it difficult to warrant a start on raising rates by the end of 2019 if the growth rate of the EU economy is on a weakening trend.

**China.** Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems. Progress has been made in reducing the rate of credit creation, particularly from the shadow banking sector, which is feeding through into lower economic growth. There are concerns that official economic statistics are inflating the published rate of growth.

**Japan** - has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy. It is likely that loose monetary policy will endure for some years yet to try to stimulate growth and modest inflation.

**Emerging countries.** Argentina and Turkey are currently experiencing major headwinds
and are facing challenges in external financing requirements well in excess of their reserves of foreign exchange. However, these countries are small in terms of the overall world economy, (around 1% each), so the fallout from the expected recessions in these countries will be minimal.

**INTEREST RATE FORECASTS**

The interest rate forecasts provided by Link Asset Services in paragraph 3.2 are **predicated on an assumption of an agreement being reached on Brexit between the UK and the EU.** On this basis, while GDP growth is likely to be subdued in 2019 due to all the uncertainties around Brexit depressing consumer and business confidence, an agreement is likely to lead to a boost to the rate of growth in 2020 which could, in turn, increase inflationary pressures in the economy and so cause the Bank of England to resume a series of gentle increases in Bank Rate. Just how fast, and how far, those increases will occur and rise to, will be data dependent. The forecasts in this report assume a modest recovery in the rate and timing of stronger growth and in the corresponding response by the Bank in raising rates.

- In the event of an **orderly non-agreement exit**, it is likely that the Bank of England would take action to cut Bank Rate from 0.75% in order to help economic growth deal with the adverse effects of this situation. This is also likely to cause short to medium term gilt yields to fall.
- If there was a **disorderly Brexit**, then any cut in Bank Rate would be likely to last for a longer period and also depress short and medium gilt yields correspondingly. It is also possible that the government could act to protect economic growth by implementing fiscal stimulus.

However, there would appear to be a majority consensus in the Commons against any form of non-agreement exit so the chance of this occurring has now substantially diminished.

**The balance of risks to the UK**

- The overall balance of risks to economic growth in the UK is probably neutral.

- The balance of risks to increases in Bank Rate and shorter term PWLB rates, are probably also even and are broadly dependent on how strong GDP growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively.

One risk that is both an upside and downside risk, is that all central banks are now working in very different economic conditions than before the 2008 financial crash as there has been a major increase in consumer and other debt due to the exceptionally low levels of borrowing rates that have prevailed for ten years since 2008. This means that the neutral rate of interest in an economy, (i.e. the rate that is neither expansionary nor deflationary), is difficult to determine definitively in this new environment, although central banks have made statements that they expect it to be much lower than before 2008. Central banks could therefore either over or under do increases in central interest rates.

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

- **Brexit** – if it were to cause significant economic disruption and a major downturn in the rate of growth.
- **Bank of England monetary policy** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **eurozone sovereign debt crisis**, possibly in **Italy**, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March of a government which has made a lot of anti-austerity noise. The EU rejected the initial proposed Italian budget and demanded cuts in government spending which the Italian government initially refused. However, a fudge was subsequently agreed, but only by *delaying* the planned increases in expenditure to a later year. This can has therefore only been kicked down the road to a later time. The rating agencies have started on downgrading Italian debt to one notch above junk level. If Italian debt were to fall below investment grade, many investors would be unable to hold it. Unsurprisingly, investors are becoming increasingly concerned by the words and actions of the Italian government and consequently, Italian bond yields have risen – at a time when the government faces having to refinance large amounts of debt maturing in 2019.
- Weak capitalisation of some **European banks**. Italian banks are particularly vulnerable; one factor is that they hold a high level of Italian government debt - debt which is falling in value. This is therefore undermining their capital ratios and raises the question of whether they will need to raise fresh capital to plug the gap.
- **German minority government.** In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. Then in October 2018, the results of the Bavarian and Hesse state elections radically undermined the SPD party and showed a sharp fall in support for the CDU. As a result, the SPD is reviewing whether it can continue to support a coalition that is so damaging to its electoral popularity. After the result of the Hesse state election, Angela Merkel announced that she would not stand for re-election as CDU party leader at her party's convention in December 2018, (a new party leader has now been elected). However, this makes little practical difference as she is still expected to aim to continue for now as the Chancellor. However, there are five more state elections coming up in 2019 and EU parliamentary elections in May/June; these could result in a further loss of electoral support for both the CDU and SPD which could also undermine her leadership.
- **Other minority eurozone governments.** Spain, Portugal, Ireland, the Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile. Sweden is also struggling to form a government due to the anti-immigration party holding the balance of power, and which no other party is willing to form a coalition with. The Belgian coalition collapsed in December 2018 but a minority caretaker government has been appointed until the May EU wide general elections.
- **Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU while **Italy,** in 2018, also elected a strongly anti-immigration government. Elections to the EU parliament are due in May/June 2019.

- Further increases in interest rates in the US could spark a **sudden flight of investment funds** from more risky assets e.g. shares, into bonds yielding a much improved yield. Throughout the last quarter of 2018, we saw sharp falls in equity markets interspersed with occasional partial rallies. Emerging countries which have borrowed heavily in dollar denominated debt, could be particularly exposed to this risk of an investor flight to safe havens e.g. UK gilts.
- There are concerns around the level of **US corporate debt** which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions. This has resulted in the debt of many large corporations being downgraded to a BBB credit rating, close to junk status. Indeed, 48% of total investment grade corporate debt is now rated at BBB. If such corporations fail to generate profits and cash flow to reduce their debt levels as expected, this could tip their debt into junk ratings which will increase their cost of financing and further negatively impact profits and cash flow.
- **Geopolitical risks,** especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

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

- **Brexit** – if both sides were to agree by 29 March a compromise that quickly removed all threats of economic and political disruption and so led to an early boost to UK economic growth.
- **The Fed causing a sudden shock in financial markets** through misjudging the pace and strength of increases in its Fed Funds Rate and in the pace and strength of reversal of QE, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.
- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- **UK inflation,** whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

**Brexit timetable and process**

- March 2017: UK government notified the European Council of its intention to leave under the Treaty on European Union Article 50 on 29 March 2019.
- 25.11.18 EU27 leaders endorsed the withdrawal agreement
- Dec 2018 vote in the UK Parliament on the agreement was postponed
- 21.12.18 – 8.1.19 UK parliamentary recess
- 15.1.19 Brexit deal defeated in the Commons vote by a large margin
- By 29.3.19 second vote (?) in UK parliament
- By 29.3.19 if the UK Parliament approves a deal, then ratification by the EU Parliament requires a simple majority
- By 29.3.19 if the UK and EU parliaments agree the deal, the EU Council needs to approve the deal; 20 countries representing 65% of the EU population must agree
- 29.3.19 Either the UK leaves the EU, or asks the EU for agreement to an extension of the Article 50 period if the UK Parliament has been unable to agree on a Brexit deal.
- 29.3.19: if an agreement is reached with the EU on the terms of Brexit, then this will be followed by a proposed **transitional period ending around December 2020.**

- UK continues as a full EU member until March 2019 with access to the single market and tariff free trade between the EU and UK. Different sectors of the UK economy may leave the single market and tariff free trade at different times during the transitional period.
- The UK and EU would attempt to negotiate, among other agreements, a bi-lateral trade agreement over that period.
- The UK would aim for a negotiated agreed withdrawal from the EU, although the UK could also exit without any such agreements in the event of a breakdown of negotiations.
- If the UK exits without an agreed deal with the EU, World Trade Organisation rules and tariffs could apply to trade between the UK and EU - but this is not certain.
- On full exit from the EU: the UK parliament would repeal the 1972 European Communities Act.

# Annex D

## TREASURY MANAGEMENT PRACTICE: PERMITTED INVESTMENTS, ASSOCIATED CONTROLS AND LIMITS

This Council approves the following forms of investment instrument for use as permitted investments

**Treasury risks**

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

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

2. **Liquidity risk:** this is the risk that cash will not be available when it is needed. While it could be said that all counterparties are subject to at least a very small level of liquidity risk as credit risk can never be zero, in this document, liquidity risk has been treated as whether or not instant access to cash can be obtained from each form of investment instrument. However, it has to be pointed out that while some forms of investment e.g. gilts, CDs, corporate bonds can usually be sold immediately if the need arises, there are two caveats: - a. cash may not be available until a settlement date up to three days after the sale b. there is an implied assumption that markets will not freeze up and so the instrument in question will find a ready buyer.

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

4. **Interest rate risk**: this is the risk that fluctuations in the levels of interest rates create an unexpected or unbudgeted burden on the organisation's finances, against which the organisation has failed to protect itself adequately. This authority has set limits for its fixed and variable rate exposure in its Treasury Indicators in this report. All types of investment instrument have interest rate risk except for the following forms of instrument which are at variable rate of interest

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

**Controls on treasury risks**

1. **Credit and counter-party risk:** this authority has set minimum credit criteria to determine which counterparties and countries are of sufficiently high creditworthiness to be considered for investment purposes. See paragraphs 5.3 and 5.4.

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

3. **Market risk:** this authority does not purchase investment instruments which are subject to market risk in terms of fluctuation in their value.

4. **Interest rate risk**: this authority manages this risk by having a view of the future course of interest rates and then formulating a treasury management strategy accordingly which aims to maximise investment earnings consistent with control of risk or alternatively, seeks to minimise expenditure on interest costs on borrowing.

5. **Legal and regulatory risk:** this authority will not undertake any form of investing until it has ensured that it has all necessary powers and also complied with all regulations. All types of investment instruments

**Unlimited investments**

Regulation 24 states that an investment can be shown as being 'unlimited' in terms of the maximum amount or percentage of the total portfolio that can be put into that type of investment. However, it also requires that an explanation must be given for using that category. The authority has given the following types of investment an unlimited category: -

1. **Debt Management Agency Deposit Facility.** This is considered to be the lowest risk form of investment available to local authorities as it is operated by the Debt Management Office which is part of H.M. Treasury i.e. the UK Government's sovereign rating stands behind the DMADF. It is also a deposit account and avoids the complications of buying and holding Government issued treasury bills or gilts.

# Annex E
## SCHEME OF DELEGATION

**(i) Full board/council**

- receiving and reviewing reports on treasury management policies, practices and activities;
- approval of annual strategy.

**(ii) Boards/committees/council/responsible body**

- approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices;
- budget consideration and approval;
- approval of the division of responsibilities;
- receiving and reviewing regular monitoring reports and acting on recommendations;
- approving the selection of external service providers and agreeing terms of appointment.

**(iii) Body/person(s) with responsibility for scrutiny**

- reviewing the treasury management policy and procedures and making recommendations to the responsible body.

**THE TREASURY MANAGEMENT ROLE OF THE SECTION 95 OFFICER**

**The S95 (responsible) officer**

- Take and/or authorise all operational decisions regarding the Council's investments and borrowing, in accordance with approved Treasury Management Policy and Strategy.
- Responsible for execution and administration of treasury management decisions in accordance with the Council's Treasury Management policy statement and Treasury Management Practice, and if (s)he is a CIPFA member, CIPFA's Standard of Professional Practice on Treasury Management.
- In terms of Treasury Management, from time to time, formulate suitable criteria for assessing and monitoring the credit risk of investment counterparties and construct a lending list defining appropriate limits.
- Borrow, in advance of need, 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. 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. Any such advance borrowing shall be reported through the mid-year or annual Treasury Management reporting mechanism.
- Take the most appropriate form of borrowing depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast contained in the Treasury Management Strategy.
- Maintain a counterparty list consistent with the Investment Counterparty Selection Criteria and revise the criteria and submit them to Committee for approval as necessary, and in addition, set out the types of investment to be made (Permitted Investments).

# Annex F

## 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.<br>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.<br>Non- local authority deposits will follow the approved credit rating criteria. | £40m, maximum 1 year. | £5m, maximum 1 year. | £40m, 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 has a “AAA” rated status from either Fitch, Moody’s or Standard and Poor’s. | £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. Ultra short dated bond funds **(low risk)** | Pooled cash investment vehicle which provides very low counterparty, liquidity and market risk. These will primarily be used as liquidity instruments. | Funds will only be used where the have a "AAA" rated status from either Fitch, Moody's or Standard and Poor's. | N/A | N/A | N/A |
| e. Call account deposit accounts with financial institutions (banks and building societies) **(Low risk depending on credit rating)** | These tend to be low risk investments, but will exhibit higher risks than categories (a), (b) and (c) above. Whilst there is no risk to value with these types of investments, liquidity is high and investments can be returned at short notice. | The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor'sDay to day investment dealing with this criteria will be further strengthened by use of additional market intelligence. | As shown in the counterparty section criteria above. | As shown in the counterparty section criteria above. | As shown in the counterparty section criteria above. |
| f. Term deposits with financial institutions (banks and building societies) **(Low to medium risk depending on period & credit rating)** | These tend to be low risk investments, but will exhibit higher risks than categories (a), (b) and (c) above. Whilst there is no risk to value with these types of investments, liquidity is low and term deposits can only be broken with the agreement of the counterparty, and penalties may apply. | The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's. Day to day investment dealing with this criteria will be further strengthened by use of additional market intelligence. | As shown in the counterparty section criteria above. | As shown in the counterparty section criteria above. | 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 |
|---|---|---|---|---|---|
| g. Government Gilts and Treasury Bills **(Very low risk)** | These are marketable securities issued by the UK Government and as such counterparty and liquidity risk is very low, although there is potential risk to value arising from an adverse movement in interest rates (no loss if these are held to maturity. | Little counterparty mitigating controls are required, as this is a UK Government investment. The potential for capital loss will be reduced by limiting the maximum monetary and time exposures. | £20m, maximum 1 year. | £5m, maximum 1 year | £20m, 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** | | | | | |
| a. Investment properties | These are non-service properties which are being held pending disposal or for a longer term rental income stream. These are highly illiquid assets with high risk to value (the potential for property prices to fall or for rental voids). | In larger investment portfolios some small allocation of property based investment may counterbalance/compliment the wider cash portfolio.<br>Property holding will be re-valued regularly and reported annually with gross and net rental streams. | £30m | £25m | N/A |
| b. Loans to third parties, including soft loans | These are service investments either at market rates of interest or below market rates (soft loans). These types of investments may exhibit credit risk and are likely to be highly illiquid. | Each third party loan requires Member approval and each application is supported by the service rational behind the loan and the likelihood of partial or full default. | £25m | £1m | N/A |
| c. Loans to a local authority company | These are service investments either at market rates of interest or below market rates (soft loans). These types of investments may exhibit credit risk and are likely to be highly illiquid. | Each loan to a local authority company requires Member approval and each application is supported by the service rational behind the loan and the likelihood of partial or full default. | £25M | N/A | N/A |
| d. National Housing Trust **(Very Low Risk due to Scottish Government Underwriting)** | 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 | 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. | £8m | N/A | N/A |

| | | | | | |
|---|---|---|---|---|---|
| | are sold. | | | | |
| e. Shareholdings in a local authority company | These are service investments which may exhibit market risk and are likely to be highly illiquid. | Each equity investment in a local authority company requires Member approval and each application will be supported by the service rational behind the investment and the likelihood of loss. | £1m | N/A | N/A |
| f. Investment in the Subordinated Debt of projects delivered via the 'HubCo' model **(Very Low Risk)** | These are investments that are exposed to the success or failure of individual projects and are highly illiquid. | The Council and Scottish Government (via the SFT) are participants in and party to the governance and controls within the project structure. As such they are well placed to influence and ensure the successful completion of the project's term.<br>These projects are based on robust business cases with a cashflow from public sector organisations (i.e. low credit risk) | £600,000 | N/A | N/A |

**The Monitoring of Investment Counterparties**

The status of counterparties will be monitored regularly. The Council receives credit rating and market information from Link Asset Services, including when ratings change, and counterparties are checked promptly. On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the Chief Financial Officer, and if required new counterparties which meet the criteria will be added to the list.

**Use of External Fund Managers**

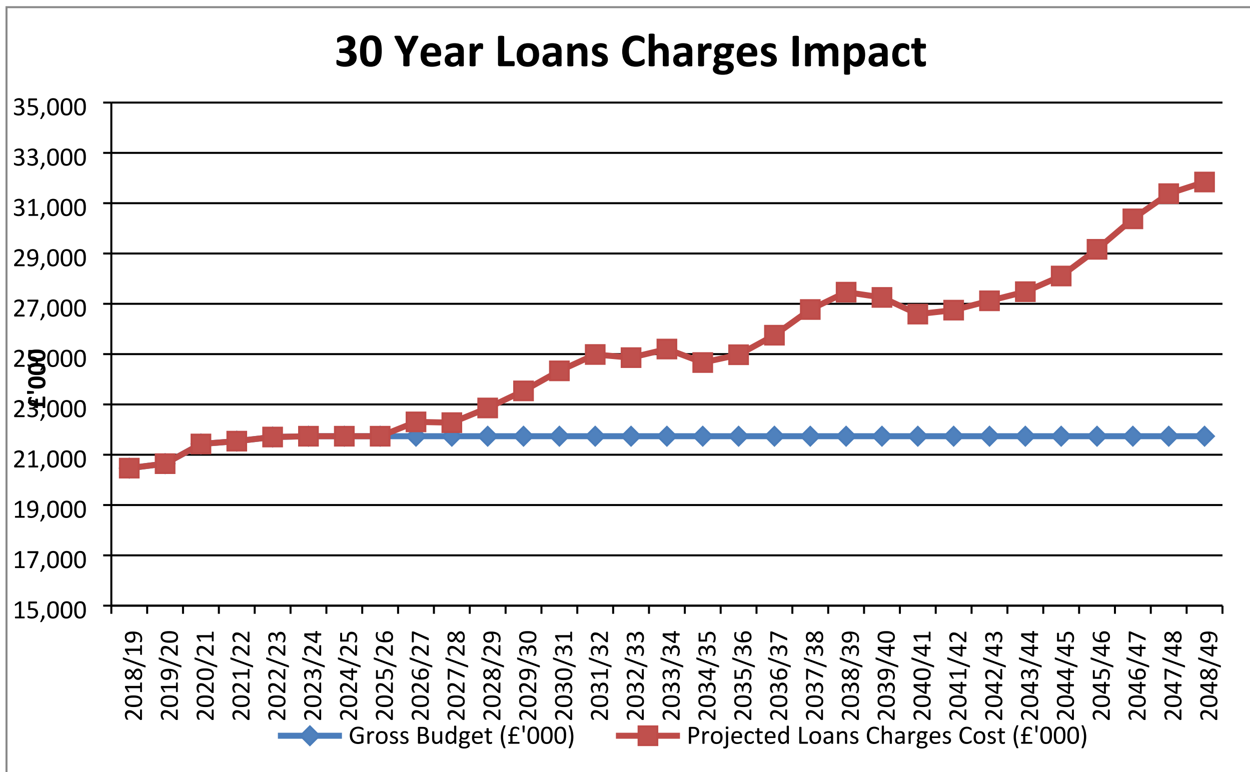
It is the Council's policy to use external fund managers to manage the investment portfolios of the Scottish Borders Council Pension Fund and the pooled investment fund of the Common Good and Trust Funds. This Annex reflects the approved policies around the Common Good and Trust Fund Investment Strategy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

## ANNEX G

## Long Term (30 Yr) Loans Charges Analysis

Current capital and revenue plans have been extrapolated over a 30 year period in order to assess the impact on the revenue Loans Charges budget. In line with assumptions made when assessing external debt and associated limits as described in paragraph 4.5 of the covering report, long term capital planning will cause a pressure on the loans charges budget from financial year 2026/27, as detailed in the chart below. Movements in notional loans charges associated with internal borrowing also impact on these figures.

It should be noted that from 2028-29, the first year outwith the current 10 year Capital Plan, a 5 year average capital expenditure and borrowing requirement has been assumed.



# ANNEX H

## Credit Ratings

## 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+<br>AA<br>AA- | F1+<br>F1+<br>F1+ | Aa1<br>Aa2<br>Aa3 | P-1<br>P-1<br>P-1 | AA+<br>AA<br>AA- | A-1+<br>A-1+<br>A-1+ |
| Strong grade<br>But susceptible to adverse conditions | A+<br>A<br>A- | F1+ / F1<br>F1<br>F1 | A1<br>A2<br>A3 | P-1<br>P-1 / P-2<br>P-1 / P-2 | A+<br>A<br>A | A-1+ / A-1<br>A-1<br>A-1 / A-2 |
| Adequate Grade | BBB+<br>BBB<br>BBB- | F2<br>F2 / F3<br>F3 | Baa1<br>Baa2<br>Baa3 | P-2<br>P-2 / P-3<br>P-3 | BBB+<br>BBB<br>BBB- | A-2<br>A-2 / A-3<br>A-2 |
| Speculative Grade | BB+<br>BB<br>BB- | B<br>B<br>B | Ba1<br>Ba2<br>Ba3 | NP *<br>NP<br>NP | BB+<br>BB<br>BB- | B-1<br>B-2<br>B-3 |
| Very Speculative Grade | B+<br>B<br>B- | B<br>B<br>B | Ba1<br>Ba2<br>Ba3 | NP<br>NP<br>NP | B+<br>B<br>B- | -<br>-<br>- |
| Vulnerable Grade | CCC<br>CCC<br>CCC<br>CC<br>C | C<br>C<br>C<br>C<br>C | Caa1<br>Caa2<br>Caa3<br>-<br>Ca | NP<br>NP<br>NP<br>NP<br>NP | CCC+<br>CCC<br>CCC-<br>CC<br>C | C<br>C<br>C<br>C<br>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

## Viability, Financial Strength and Support Ratings

Continuing regulatory changes in the banking sector designed to see greater stability, lower risk and the removal of expectations of Government financial support should an institution fail. This withdrawal of implied sovereign support is anticipated to have an effect on ratings applied to institutions. This will result in the key rating agency information used to monitor counterparties will be the Short Term and Long Term ratings only. Viability, Financial Strength and Support Ratings previously applied will effectively become redundant. This change does not reflect deterioration in the credit environment but rather a change of method in response to regulatory changes

As a result of these rating agency changes, the credit element of creditworthiness methodology applied by Link Asset Services will focus solely on the Short and Long Term ratings of an institution. Rating Watch and Outlook information will continue to be assessed where it relates to these categories. This is the same process for Standard & Poor's that has always taken, but a change to the use of Fitch and Moody's ratings. Furthermore, Credit Default Swap prices will continue to be used as an overlay to ratings in our new methodology.

## 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 liquidity, 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 to be used is:

- **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 the Creditworthiness service provided by Capita Asset Services. 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 |
| **CFR** | Capital Financing Requirement is the estimated 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<br>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 |
| **NHT** | National Housing Trust initiative undertaken in partnership with the Scottish Futures Trust. |
| **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. |

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

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