Treasury Management Strategy Statement

and Annual Investment Strategy 2013-14

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1 INTRODUCTION

1.1 Background

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

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

CIPFA defines treasury management as:

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

1.2 Reporting requirements

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

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

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

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

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

1.3 Treasury Management Strategy for 2013/14

The strategy for 2013/14 covers two main areas:

Capital issues

- the capital plans and the prudential indicators..

Treasury management issues

- the current treasury position;
- treasury indicators which limit the treasury risk and activities of the Council;
- prospects for interest rates;
- the borrowing strategy;
- policy on borrowing in advance of need;
- debt rescheduling;
- the investment strategy;
- creditworthiness policy; and
- policy on use of external service providers.

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

1.4 Treasury management consultants

The Council uses Sector as its external treasury management advisors.

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

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

2 THE CAPITAL PRUDENTIAL INDICATORS 2013/14 – 2015/16

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

2.1 Capital expenditure

This prudential indicator is a summary of the Council's capital expenditure plans.

Capital expenditure £'000	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Community Services	6,685	11,642	9,553	23,781	9,080
Customer Services	1,550	3,164	7,290	2,607	2,314
Development and Infrastructure Services	16,870	19,710	9,697	11,865	9,528
CHORD	470	8,605	8,505	3,573	3,794
Total	**25,575**	**43,121**	**35,045**	**41,826**	**24,716**

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

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

Capital expenditure £'000	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Total cap. expenditure	25,575	43,121	35,045	41,826	24,716
Financed by:					
Capital receipts					
Capital grants	11,479	9,656	9,043	13,705	13,077
Capital reserves			2,200		250
Revenue	124		4,216	3,869	
Net financing need for the year	**13,972**	**33,465**	**19,586**	**24,252**	**11,389**

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

The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

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

The CFR includes any other long term liabilities (e.g. PFI schemes, finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes. The Council currently has £82.6m of such schemes within the CFR.

The Council is asked to approve the CFR projections below:

£'000	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Capital Financing Requirement					
Opening CFR	264,977	256,617	271,150	272,695	279,355
Closing CFR	256,617	271,150	272,695	279,355	278,621
Movement in CFR	**-8,360**	**14,533**	**1,545**	**6,660**	**-734**

Movement in CFR represented by					
Net financing need for the year (above)	13,972	33,465	19,586	24,252	11,389
Less Scheduled debt Amortisation	22,332	18,932	18,041	17,592	12,123
Movement in CFR	**-8,360**	**14,533**	**1,545**	**6,660**	**-734**

2.3 Core funds and expected investment balances

The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc.). Detailed below are estimates of the year end investment balances.

Year End Resources £'000	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Expected investments	**37,962**	**35,000**	**25,000**	**20,000**	**15,000**

2.4 Affordability prudential indicators

The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. The Council is asked to approve the following indicators:

2.5 Ratio of financing costs to net revenue stream.

This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

%	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Non-HRA	11.65%	10.68%	10.69%	10.45%	10.22%

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

2.6 Incremental impact of capital investment decisions on council tax.

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

Incremental impact of capital investment decisions on the band D council tax

£	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Council tax - band D	-14.77	35.34	6.28	17.68	1.15

3 Treasury Management Strategy

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

3.1 Current portfolio position

The Council's treasury portfolio position at 31 March 2012, with forward projections are summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

£'000	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
External Debt					
Debt at 1 April	160,365	160,407	160,407	170,407	175,407
Expected change in Debt	42		10,000	5,000	5,000
Other long-term liabilities (OLTL)	83,386	81,760	80,485	79,218	77,968
Expected change in OLTL	-1,626	-1,275	-1,267	-1,250	-1,250
Actual gross debt at 31 March	**242,167**	**240,892**	**249,625**	**253,375**	**257,125**
The Capital Financing Requirement	**256,617**	**271,150**	**272,695**	**279,355**	**278,621**
Under / (over) borrowing	**14,450**	**30,258**	**23,070**	**25,980**	**21,496**

Within the prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2013/14 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

The Head of Strategic Finance reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

3.2 Treasury Indicators: Limits to Borrowing Activity

The Operational Boundary. This is the limit beyond which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt.

Operational Boundary £'m	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Debt	226	226	235	235
Other long term liabilities	94	94	94	94
Total	320	320	329	329

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

1. 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.
2. The Council is asked to approve the following Authorised Limit:

Authorised Limit £'m	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Debt	231	231	240	240
Other long term liabilities	95	95	95	95
Total	326	326	335	335

3.3 Prospects for interest rates

The Council has appointed Sector as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. Appendix 1 draws together a number of current City forecasts for the short term (Bank Rate) and longer fixed interest rates.

The following table gives the Sector central view.

Annual Average %	Bank Rate	PWLB Borrowing Rates (including certainty rate adjustment)		
		5 year	25 year	50 year
March 2013	0.50	1.50	3.80	4.00
June 2013	0.50	1.50	3.80	4.00
Sept 2013	0.50	1.60	3.80	4.00
Dec 2013	0.50	1.60	3.80	4.00
March 2014	0.50	1.70	3.90	4.10
June 2014	0.50	1.70	3.90	4.10
Sept 2014	0.50	1.80	4.00	4.20
Dec 2014	0.50	2.00	4.10	4.30
March 2015	0.75	2.20	4.30	4.50
June 2015	1.00	2.30	4.40	4.60
Sept 2015	1.25	2.50	4.60	4.80
Dec 2015	1.50	2.70	4.80	5.00
March 2016	1.75	2.90	5.00	5.20

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

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

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

- The Eurozone sovereign debt difficulties provide a clear indication of high counterparty risk. This continues to suggest the use of higher quality counterparties for shorter time periods;
- Investment returns are likely to remain relatively low during 2013/14 and beyond;
- Borrowing interest rates continue to be attractive and may remain relatively low for some time. The timing of any borrowing will need to be monitored carefully;
- There will remain a cost of carry – any borrowing undertaken that results in an increase in investments will incur a revenue loss between borrowing costs and investment returns.

3.4 Borrowing strategy

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

Against this background and the risks within the economic forecast, caution will be adopted with the 2013/14 treasury operations. The Head of Strategic Finance will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

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

- if it was felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast, perhaps arising from a greater than expected increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates were still relatively cheap.

Any decisions will be reported to the appropriate decision making body at the next available opportunity.

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:

- Upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates based upon the debt position net of investments;
- Upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates;
- Maturity structure of borrowing. These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

The Council is asked to approve the following treasury indicators and limits:

%	2013/14	2014/15	2015/16
Interest rate exposures			
	Upper	**Upper**	**Upper**
Limits on fixed interest rates based on net debt	180%	140%	140%
Limits on variable interest rates based on net debt	90%	90%	90%
Maturity structure of fixed interest rate borrowing 2013/14			
		Lower	**Upper**
Under 12 months		0%	30%
12 months to 2 years		0%	30%
2 years to 5 years		0%	30%
5 years to 10 years		0%	40%
10 years and above		0%	80%

3.5 Policy on Borrowing in Advance of Need

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

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

3.6 Debt Rescheduling

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

The reasons for any rescheduling to take place will include:

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

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

All rescheduling will be reported to the Council at the earliest meeting following its action

4 ANNUAL INVESTMENT STRATEGY

4.1 Investment Policy

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

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

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

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.

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

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

Investment instruments identified for use in the financial year are listed in appendices 5.3 and 5.4. Counterparty limits will be as set through the Council's Treasury Management Practices – Schedules.

4.2 Creditworthiness policy

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

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

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

- Yellow 5 years *
- Purple 2 years
- Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange 1 year
- Red 6 months
- Green 3 months
- No colour not to be used

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

Typically the minimum credit ratings criteria the Council use will be a short term rating (Fitch or equivalents) of short term rating F1, long term rating A-, viability rating of A-, and a support rating of 1 There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

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

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

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

4.3 Country limits

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

4.4 Council Permitted Investments

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

The permitted investment which may be used in the forthcoming year:

Cash Type Instruments

a. Deposits with the Debt Management Account Facility (UK Government);

b. Deposits with other local authorities or public bodies;

c. Money Market Funds;

d. Call account deposit accounts with financial institutions (banks and building societies);

e. Term deposits with financial institutions (banks and building societies);

f. UK Government Gilts and Treasury Bills;

g. Supranational Bonds (e.g. World Bank)

h. Certificates of deposits with financial institutions (banks and building societies);

i. Structured deposit facilities with banks and building societies (escalating rates, de-escalating rates etc.);

j. Corporate Bonds;

k. Bond Funds;

l. Property Funds;

Other Funds

m. Investment properties;

n. Loans to third parties, including soft loans;

o. Loans to local authority company;

p. Shareholdings in a local authority company;

q. Non-local authority shareholdings.

Details of the risks, mitigating controls and limits associated with each of these permitted categories are shown in Appendix 5.4.

Common Good permitted investments are also shown at Appendix 5.4, and where applicable the same counterparty selection criteria will be applied.

For those permitted cash type investments the Head of Strategic Finance will maintain a counterparty list in compliance with the counterparty selection criteria as stated above. These criteria select which counterparties the Council choose from, rather than defining what its investments are.

4.5 Investment strategy

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

Investment returns expectations. Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 1 of 2015. Bank Rate forecasts for financial year ends (March) are:

- 2012/13 0.50%
- 2013/14 0.50%
- 2014/15 0.75%
- 2015/16 1.75%

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

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

2012/13	0.50%
2013/14	0.50%
2014/15	0.60%
2015/16	1.50%

Investment treasury indicator and limit - total principal funds invested for greater than 364 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

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

Maximum principal sums invested > 364 days			
£m	**2013/14**	**2014/15**	**2015/16**
Principal sums invested > 364 days	£20	£20	£20

For its cash flow generated balances, the Council will seek to utilise its business reserve accounts, 15, 30 and 90 day notice accounts, money market funds and short-dated deposits (overnight to 364 days) in order to benefit from the compounding of interest.

4.6 End of Year Investment Report

At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

4.7 External Fund Managers

The Council at present does not use a fund manager but it is the intention to use a manager during 2013-14.

4.8 Policy on the Use of External Service Providers

The Council uses Sector as its external treasury management advisors.

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

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

4.9 Scheme of Delegation

Please see Appendix 5.6.

4.10 Role of the Section 95 Officer

Please see Appendix 5. 7.

4.11 Treasury Management Policy

Please see Appendix 5.8.

5 Appendices

1. Interest rate forecasts
2. Economic background
3. Treasury management practice (TMP1) – permitted investments
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5. Approved countries for investments
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5.1 APPENDIX: Interest Rate Forecasts 2013 – 2016

Sector's Interest Rate View														
	Now	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
Sector's Bank Rate View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%
3 Month LIBID	0.39%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.60%	0.60%	0.70%	0.80%	1.10%	1.40%	1.70%
6 Month LIBID	0.54%	0.70%	0.70%	0.70%	0.70%	0.70%	0.70%	0.80%	0.90%	1.00%	1.10%	1.30%	1.60%	1.90%
12 Month LIBID	0.88%	1.00%	1.00%	1.00%	1.00%	1.00%	1.10%	1.10%	1.20%	1.30%	1.30%	1.50%	1.80%	2.10%
5yr PWLB Rate	1.85%	1.50%	1.50%	1.60%	1.60%	1.70%	1.70%	1.80%	2.00%	2.20%	2.30%	2.50%	2.70%	2.90%
10yr PWLB Rate	2.87%	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%	3.30%	3.50%	3.70%	3.90%
25yr PWLB Rate	4.02%	3.80%	3.80%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.30%	4.40%	4.60%	4.80%	5.00%
50yr PWLB Rate	4.15%	4.00%	4.00%	4.00%	4.00%	4.10%	4.10%	4.20%	4.30%	4.50%	4.60%	4.80%	5.00%	5.20%
Bank Rate														
Sector's View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%
UBS	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-
Capital Economics	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-
5yr PWLB Rate														
Sector's View	1.85%	1.50%	1.50%	1.60%	1.60%	1.70%	1.70%	1.80%	2.00%	2.20%	2.30%	2.50%	2.70%	2.90%
UBS	1.85%	-	-	-	-	-	-	-	-	-	-	-	-	-
Capital Economics	1.85%	1.55%	1.30%	1.30%	1.30%	1.30%	1.30%	1.50%	1.60%	-	-	-	-	-
10yr PWLB Rate														
Sector's View	2.87%	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%	3.30%	3.50%	3.70%	3.90%
UBS	2.87%	3.00%	3.10%	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	-	-	-	-	-
Capital Economics	2.87%	2.55%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	-	-	-	-	-
25yr PWLB Rate														
Sector's View	4.02%	3.80%	3.80%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.30%	4.40%	4.60%	4.80%	5.00%
UBS	4.02%	4.20%	4.30%	4.40%	4.50%	4.50%	4.50%	4.50%	4.50%	-	-	-	-	-
Capital Economics	4.02%	3.70%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	-	-	-	-	-
50yr PWLB Rate														
Sector's View	4.15%	4.00%	4.00%	4.00%	4.00%	4.10%	4.10%	4.20%	4.30%	4.50%	4.60%	4.80%	5.00%	5.20%
UBS	4.15%	4.30%	4.40%	4.50%	4.60%	4.60%	4.60%	4.60%	4.60%	-	-	-	-	-
Capital Economics	4.15%	4.00%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	-	-	-	-	-

5.2 APPENDIX: Economic Background

The Global economy

The Eurozone debt crisis has continued to cast a pall over the world economy and has depressed growth in most countries. This has impacted the UK economy which is unlikely to grow significantly in 2012 and is creating a major headwind for recovery in 2013. Quarter 2 of 2012 was the third quarter of contraction in the economy; this recession is the worst and slowest recovery of any of the five recessions since 1930. A return to growth @ 0.9% in quarter 3 in unlikely to prove anything more than a washing out of the dip in the previous quarter before a return to weak, or even negative, growth in quarter 4; this would leave overall growth in 2012 close to zero and could lead into negative growth in quarter 1 of 2013, which would then mean that the UK was in its first triple dip recession since records began in 1955.

The **Eurozone sovereign debt crisis** has abated somewhat following the ECB's commitment to a programme of Outright Monetary Transactions i.e. a pledge to buy unlimited amounts of bonds of countries which ask for a bailout. The immediate target for this statement was Spain which continues to prevaricate on making such a request , (for a national bailout), and so surrendering its national sovereignty to IMF supervision. However, the crisis in Greece has subsided, for the time being, as a result of the Eurozone agreement to provide a further €50bn financial support package in December. Many commentators, though, still view a Greek exit from the Euro as being likely in the longer term as successive rounds of austerity packages could make it more difficult to bring down the annual deficit and total debt as ratios of GDP due to the effect they have on shrinking the economy and reducing employment and tax revenues. However, another possible way out would be a major write down of total Greek debt; this has now been raised by the German Chancellor as a possible course of action, but not until 2014-15, and provided the Greek annual budget is in balance.

Sentiment in financial markets has improved considerably since this ECB action and additional financial support for Greece to ensure that the Eurozone remained intact during 2012. However, the foundations to this "solution" to the Eurozone debt crisis are still weak and do not address the huge obstacle of unemployment rates of over 25% in Greece and Spain. It is also possible that the situations in Portugal and Cyprus could deteriorate further in 2013 and, although they are minor economies, such developments could unnerve financial markets. There are also general elections coming up in Italy and Germany which could potentially produce some upsets on the political scene. It is, therefore, quite possible that sentiment in financial markets could turn during 2013 after the initial burst of optimism at the start of the year. While equity prices have enjoyed a strong start to 2013, the foundations for this stock market recovery are shallow given the economic fundamentals in western economies. In addition, QE has to come to an end at some point in time and there is a distinct increase in doubt in the central banks of the US and UK as to the effectiveness of any further QE in stimulating economic growth. An end to central purchases of bonds may lead to a fall in bond prices.

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

The fiscal cliff, and raising the total debt ceiling, still await final resolution by the end of February. The housing market, though, does look as if it has, at long last, reached the bottom and house prices are now on the up.

Hopes for a broad based recovery have, therefore, focused on the **emerging markets**. Recent news from China appears to indicate that the economy has returned to a healthier rate of growth. However, there are still concerns around the unbalanced nature of the economy which is heavily dependent on new investment expenditure. The potential for the bubble in the property sector to burst, as it did in Japan in the 1990s, could have a material impact on the economy as a whole.

The UK economy

The Government's austerity measures, aimed at getting the public sector deficit into order, have now had to be extended, in the autumn statement, over a longer period than the original four years. Achieving this new extended timeframe will still be dependent on the UK economy returning to a reasonable pace of growth towards the end of this period.

Currently, the UK is enjoying a major financial benefit from some of the lowest sovereign borrowing costs in the world as the UK is seen as a safe haven from Eurozone debt. However, the subsiding of market concerns over the Eurozone has unwound some of the attractiveness of gilts as a safe haven and led to a significant rise in gilt yields. There is little evidence that UK consumer confidence levels are recovering, nor that the manufacturing sector is picking up. The dominant services sector disappointed in December with the PMI survey indicating the first fall in activity in two years. On the positive side, banks have made huge progress since 2008 in shrinking their balance sheets to more manageable levels and also in reducing their dependency on wholesale funding. However, availability of credit remains tight in the economy and the Funding for Lending scheme, which started in August 2012, has not yet had time to make a significant impact in respect of materially increasing overall borrowing in the economy. Finally, the housing market remains tepid and the outlook is for house prices to be little changed for a prolonged period.

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

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

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

AA rating. The UK has been down graded to AA sovereign rating. The three main credit agencies will be carefully monitoring the rate of growth in the economy as a disappointing performance in that area could lead to a major derailment of the plans to contain the growth in the total amount of Government debt over the next few years.

Sector's forward view

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

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

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

- the impact of the Eurozone crisis on financial markets and the banking sector;

- the impact of the Government's austerity plan on confidence and growth and the need to rebalance the economy from services to manufactured goods;

- the under-performance of the UK economy which could undermine the Government's policies that have been based upon levels of growth that are unlikely to be achieved;

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

- stimulus packages failing to stimulate growth;

- elections due in Italy and Germany in 2013;

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

- the potential for action to curtail the Iranian nuclear programme

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

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

Given the weak outlook for economic growth, Sector sees the prospects for any changes in Bank Rate before 2015 as very limited. There is potential for the start of Bank Rate increases to be even further delayed if growth disappoints.

Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries. The interest rate forecast in this report represents a balance of downside and upside risks. The downside risks have already been commented on. However, there are specific identifiable upside risks as follows to PWLB rates and gilt yields, and especially to longer term rates and yields: -

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

5.3 APPENDIX: Treasury Management Practice (TMP1) - Permitted Investments

This Council approves the following forms of investment instrument for use as permitted investments as set out in table 1 and 2.

Treasury risks
All the investment instruments in tables 1 and 2 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 a very high level of creditworthiness.

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

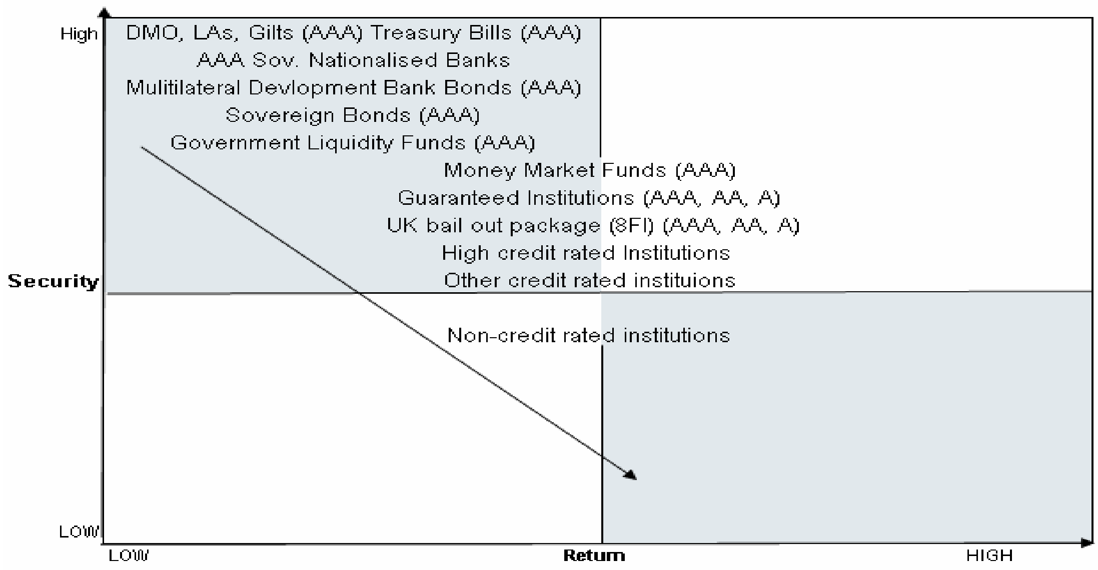
3. **Market risk:** this is the risk that, through adverse market fluctuations in the value of the principal sums an organisation borrows and invests, its stated treasury management policies and objectives are compromised, against which effects it has failed to protect itself adequately. However, some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

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

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

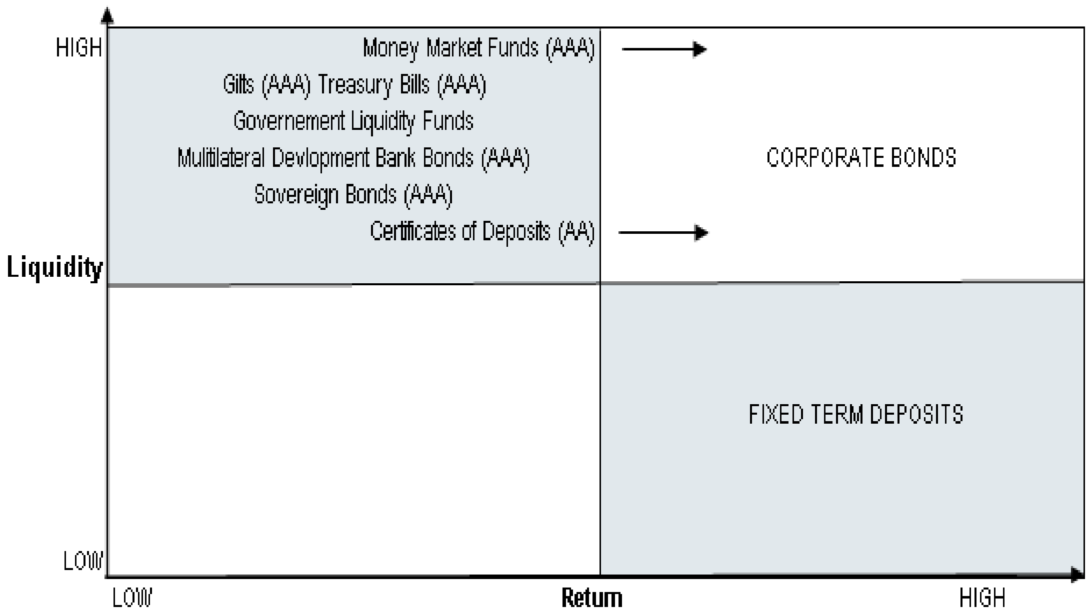
The graph below summarises the risk exposure of various types of investment instrument. It shows that as you move from top to bottom, so the level of credit risk increases. However, moving from top to bottom also results in moving towards the right i.e. returns increase. The overall message is: -

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



The next graph shows the other message: -

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



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 high creditworthiness to enable investments to be made safely. See paragraphs 4.2 and 4.3.

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

3. **Market risk:** this authority 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. See paragraph 4.4.

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

Unlimited investments

Regulation 24 states that an investment can be shown in tables 1 and 2 as being 'unlimited' in terms of the maximum amount or percentage of the total portfolio that can be put into that type of investment. However, it also requires that an explanation must be given for using that category.

The authority has given the following types of investment an unlimited category: -

1. **Debt Management Agency Deposit Facility.** 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 AAA 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.

2. **High credit worthiness banks and building societies.** See paragraph 4.2 for an explanation of this authority's definition of high credit worthiness. While an unlimited amount of the investment portfolio may be put into banks and building societies with high credit worthiness, the authority will ensure diversification of its portfolio ensuring that no more than £30m of the total portfolio can be placed with any one institution or group.

Objectives of each type of investment instrument

Regulation 25 requires an explanation of the objectives of every type of investment instrument which an authority approves as being 'permitted':-

1. DEPOSITS

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

a) **Debt Management Agency Deposit Facility.** This offers the lowest risk form of investment available to local authorities as it is effectively an investment placed with the Government. It is also easy to use as it is a deposit account and avoids the complications of buying and holding Government issued treasury bills or gilts. As it is low risk it also earns low rates of interest. However, it is very useful for authorities whose overriding priority is the avoidance of risk at a time when many authorities are disappointed at the failure in 2008 of credit ratings to protect investors from the Icelandic bank failures and are both cautious about other forms of investing and are prepared to bear the loss of income to the treasury management budget compared to earnings levels in previous years. The longest term deposit that can be made with the DMADF is 6 months.

b) **Term deposits with high credit worthiness banks and building societies.** See paragraph 4.7 for an explanation of this authority's definition of high credit worthiness. This is the most widely used form of investing used by local authorities. It offers a much higher rate of return than the DMADF (dependent on term) and now that measures have been put in place to avoid over reliance on credit ratings, the authority feels much more confident that the residual risks around using such banks and building societies are at a low, reasonable and acceptable level. The authority will ensure diversification of its portfolio of deposits ensuring that no more than £20m of the total portfolio can be placed with any one institution or group. In addition, longer term deposits offer an opportunity to increase investment returns by locking in high rates ahead of an expected fall in the level of interest rates. At other times, longer term rates can offer good value when the markets incorrectly assess the speed and timing of interest rate increases. This form of investing therefore, offers a lot of flexibility and higher earnings than the DMADF. Where it is restricted is that once a longer term investment is made, that cash is locked in until the maturity date.

c) **Call accounts with high credit worthiness banks and building societies.** The objectives are as for 1b. but there is instant access to recalling cash deposited. This generally means accepting a lower rate of interest than that which could be earned from the same institution by making a term deposit. However, there are a number of call accounts which at the time of writing, offer rates 2 – 3 times more than term deposits with the DMADF. Some use of call accounts is highly desirable to ensure that the authority has ready access to cash when needed to pay bills.

d) **Fixed term deposits with variable rate and variable maturities (structured deposits).** This line encompasses ALL types of structured deposits. There has been considerable change in the types of structured deposits brought to the market over the last few years, some of which are already no longer available. In view of the fluidity of this area, this is a generic title for all structured deposits so as to provide councils with greater flexibility to adopt new instruments as and when they are brought to the market. However, this does mean that members ought to be informed as to what instruments are presently under this generic title so that they are aware of the current situation, and that they are informed and approve of intended changes in an appropriate manner.

e) **Collateralised deposits.** These are deposits placed with a bank which offers collateral backing based on LOBOs borrowed by local authorities. Such deposits are effectively lending to a local authority as that is the ultimate security.

2. DEPOSITS WITH COUNTERPARTIES CURRENTLY IN RECEIPT OF GOVERNMENT SUPPORT / OWNERSHIP

These banks offer another dimension of creditworthiness in terms of Government backing through either direct (partial or full) ownership or the banking support package. The view of this authority is that such backing makes these banks attractive institutions with whom to place deposits, and that will remain our view if the UK sovereign rating were to be downgraded in the coming year.

a. **Term deposits with high credit worthiness banks which are fully or semi nationalised.** As for 1b. but Government ownership partial or full implies that the Government stands behind this bank and will be deeply committed to providing whatever support that may be required to ensure the continuity of that bank. This authority considers this indicates a low and acceptable level of residual risk.

b. **Term deposits with high credit worthiness banks and building societies which are specified as being eligible for support by the UK Government.** As for 2a. but Government stated support implies that the Government stands behind eligible banks and building societies and will be deeply committed to providing whatever support that may be required to ensure the continuity of such institutions. This authority considers this indicates a low and acceptable level of residual risk.

c. **Fixed term deposits with variable rate and variable maturities (structured deposits).** This line encompasses ALL types of structured deposits. There has been considerable change in the types of structured deposits brought to the market over the last few years, some of which are already no longer available. In view of the fluidity of this area, this is a generic title for all structured deposits so as to provide councils with greater flexibility to adopt new instruments as and when they are brought to the market. However, this does mean that members ought to be informed as to what instruments are presently covered under this generic title so that they are aware of the current situation, and that they are informed and approve of intended changes in an appropriate manner.

3. COLLECTIVE INVESTMENT SCHEMES STRUCTURED AS OPEN ENDED INVESTMENT COMPANIES (OEICS)

a. **Government liquidity funds.** These are very similar to money market funds (see below) but only invest in government debt issuance with highly rated governments. They offer a lower rate of return than MMFs but slightly higher than the returns from the DMADF.

b. **Money Market Funds (MMFs).** By definition, MMFs are AAA rated and are widely diversified, using many forms of money market securities including types which this authority does not currently have the expertise or risk appetite to hold directly. However, due to the high level of expertise of the fund managers and the huge amounts of money invested in MMFs, and the fact that the weighted average maturity (WAM) cannot exceed 60 days, MMFs offer a combination of high security, instant access to funds, high diversification and good rates of return compared to equivalent instant access facilities. They are particularly advantageous in falling interest rate environments as their 60 day WAM means they have locked in investments earning higher rates of interest than are currently available in the market. MMFs also help an authority to diversify its own portfolio as e.g. a £2m investment placed directly with HSBC is a 100% risk exposure to HSBC whereas £2m invested in a MMF may end up with say £10,000 being invested with HSBC through the MMF. For authorities particularly concerned with risk exposure to banks, MMFs offer an effective way of minimising risk exposure while still getting much better rates of return than available through the DMADF. They also offer a constant Net Asset Value (NAV) i.e. the principal sum invested has high security.

c. **Enhanced cash funds.** These funds are similar to MMFs, can still be AAA rated but have variable Net Asset Values (NAV) as opposed to a traditional MMF which has a stable NAV. They aim to achieve a higher yield and to do this either take more credit risk or invest out for longer periods of time, which means they are more volatile. These funds can have WAM's and Weighted Average Life (WAL's) of 90 – 365 days or even longer. Their primary objective is yield and capital preservation is second. They therefore are a higher risk than MMFs and correspondingly have the potential to earn higher returns than MMFs.

d. **Gilt funds.** These are funds which invest only in U.K. Government gilts. They offer a lower rate of return than bond funds but are highly rated both as a fund and through investing only in AAA rated gilts. They offer a higher rate of return than investing in the DMADF but they do have an exposure to movements in market prices of assets held.

e. **Bond funds.** These invest in both government and corporate bonds. This therefore entails a higher level of risk exposure than gilt funds and the aim is to achieve a higher rate of return than normally available from gilt funds by trading in bonds. They do have an exposure to movements in market prices of assets held so do not offer constant Net Asset Value.

4. SECURITIES ISSUED OR GUARANTEED BY GOVERNMENTS

The following types of investments are where an authority directly purchases a particular investment instrument, a security, i.e. it has a market price when purchased and that value can change during the period the instrument is held until it matures or is sold. The annual earnings on a security is called a yield i.e. it is normally the interest paid by the issuer divided by the price you paid to purchase the security unless a security is initially issued at a discount e.g. treasury bills..

b. **Treasury bills.** These are short term bills (up to 12 months) issued by the Government and so are backed by the sovereign rating of the UK. The yield is higher than the rate of interest paid by the DMADF and another advantage compared to a time deposit in the DMADF is that they can be sold if there is a need for access to cash at any point in time. However, there is a spread between purchase and sale prices so early sales could incur a net cost during the period of ownership.

c. **Gilts.** These are longer term debt issuance by the UK Government and are backed by the sovereign rating of the UK. The yield is higher than the rate of interest paid by the DMADF and another advantage compared to a time deposit in the DMADF is that they can be sold if there is a need for access to cash at any point in time. However, there is a spread between purchase and sale prices so early sales may incur a net cost. The advantage over Treasury bills is that they generally offer higher yields the longer it is to maturity (for most periods) if the yield curve is positive.

d. **Bond issuance issued by a financial institution which is explicitly guaranteed by the UK Government** (refers solely to GEFCO - Guaranteed Export Finance Corporation). This is similar to gilt due to the explicit Government guarantee.

e. **Sovereign bond issues (other than the UK govt) denominated in Sterling.** As for gilts but issued by other nations. AAA rated issues are just as secure as UK Government gilts but the advantage of these securities is they offer a slightly higher yield.

f. **Bonds issued by Multi Lateral Development Banks (MLDBs).** These are similar to c. and e. above but are issued by MLDBs which are guaranteed by sovereign states with a high sovereign rating e.g. European Investment Bank. The advantages of these securities is they are more secure than UK Government gilts, as they are guaranteed by more than one AAA rated government, and offer a slightly higher yield.

5. SECURITIES ISSUED BY CORPORATE ORGANISATIONS

The following types of investments are where an authority directly purchases a particular investment instrument, a security, i.e. it has a market price when purchased and that value can change during the period the instrument is held until it is sold. The annual earnings on a security is called a yield i.e. is the interest paid by the issuer divided by the price you paid to purchase the security. These are similar to the previous category but corporate organisations can have a wide variety of credit worthiness so it is essential for local authorities to only select the organisations with the highest levels of credit worthiness. Corporate securities are generally a higher risk than government debt issuance and so earn higher yields.

a. **Certificates of deposit (CDs).** These are shorter term securities issued by deposit taking institutions (mainly banks) so they can be sold if there is a need for access to cash at any point in time. However, that liquidity comes at a price so the yield is less than placing a deposit with the same bank as the issuing bank.

b. **Commercial paper.** This is similar to CDs but is issued by commercial organisations or other entities. Maturity periods are up to 365 days but commonly 90 days.

c. **Corporate bonds.** These are (long term) bonds (usually bearing a fixed rate of interest) issued by a company or other non-government issuer in order to raise capital for the institution as an alternative to issuing shares or borrowing from banks. They are generally seen to be of a lower creditworthiness than government issued debt and so usually offer higher rates of yield.

d. **Floating rate notes.** These are bonds on which the rate of interest is established periodically with reference to short-term interest rates.

6. OTHER

a. **Property fund.** This is a collective investment fund specialising in property. Rather than owning a single property with all the risk exposure that means to one property in one location rising or falling in value, maintenance costs, tenants actually paying their rent / lease etc, a collective fund offers the advantage of diversified investment over a wide portfolio of different properties. This can be attractive for authorities who want exposure to the potential for the property sector to rise in value. However, timing is critical to entering or leaving this sector at the optimum times of the property cycle of rising and falling values unless a long term commitment is made to retain exposure to the property market.

b. **Local Authority Mortgage Scheme.** Authorities who are participating in the Local Authority Mortgage Guarantee Scheme (LAMGS) may be required to place a deposit with the mortgage provider(s) up to the full value of the guarantee. The deposit will be in place for the term of the guarantee i.e. 5 years (with the possibility of a further 2 year extension if the account is 90+ days in arrears at the end of the initial 5 years) - and may have conditions / structures attached. The mortgage provider will not hold a legal charge over the deposit. The Council limits are to deposit a maximum of £3m for a period of 5 years with the mortgage provider in pursuance of the Council's policy of supporting first time buyers as agreed by the Council on 20 August 2012.

b.

Table 1: permitted investments in house – Common Good

This table is for use by the in house treasury management team.

1.1 Deposits

	Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Debt Management Agency Deposit Facility	--	term	no	100	2 years
Term deposits – local authorities	--	term	no	100	2 years
Call accounts – banks and building societies	Green	instant	no	100	Call
Term deposits – banks and building societies	Green	term	no	100	2 years
Fixed term deposits with variable rate and variable maturities: - Structured deposits.	Green	term	no	50	2 years
Collateralised deposit	AAA	term	no	30	1 year

1.2 Deposits with counterparties currently in receipt of government support / ownership

	Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
UK nationalised banks	Blue	term	no	100	1 year
Banks nationalised by high credit rated (sovereign rating) countries – non UK	AA+	term	no	100	1 year
Government guarantee (explicit) on ALL deposits by high credit rated (sovereign rating) countries	AA+	term	no	100	1 year
UK Government support to the banking sector (implicit guarantee)	UK sovereign rating	term	no	100	1 year
Fixed term deposits with variable rate and variable maturities: - Structured deposits	Sovereign rating	term	no	100	1 year

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

	Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
1. Government Liquidity Funds	AAA	instant	No see note A	20	1 year
2. Money Market Funds	AAA	instant	No see note A	20	1 year
3. Enhanced cash funds	AAA	T+>1	yes	20	1 year
4. Gilt Funds	AAA	T+>1	yes	20	1 year
5. Bond Funds	AAA	T+>1	yes	20	1 year

Note A: the objective of this fund to maintain the net asset value but they hold assets which can vary in value. However, the credit rating agencies require the fluctuation in unit values held by investors to vary by almost zero.

1.4 Securities issued or guaranteed by governments

	Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Treasury Bills	UK sovereign rating	Sale T+1	yes	20	1 year
UK Government Gilts	UK sovereign rating	Sale T+1	yes	20	1 year
Bond issuance issued by a financial institution which is explicitly guaranteed by the UK Government (refers solely to GEFCO - Guaranteed Export Finance Corporation)	UK sovereign rating	Sale T+3	yes	20	1 year
Sovereign bond issues (other than the UK govt)	AAA	Sale T+1	yes	20	1 year
Bonds issued by multilateral development banks	AAA	Sale T+1	yes	20	1 year

1.5 Securities issued by corporate organisations

	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Certificates of deposit issued by banks and building societies covered by UK Government (explicit) guarantee	UK sovereign rating	Sale T+1	yes	50	2 years
Certificates of deposit issued by banks and building societies	UK sovereign rating	Sale T+1	yes	50	2 years
Commercial paper issuance covered by a specific UK Government (explicit) guarantee	UK sovereign rating	Sale T+1	yes	20	2 years
Commercial paper other	AA	Sale T+1	yes	20	2 years
Corporate Bonds issuance covered by UK Government (implicit) guarantee	UK sovereign rating	Sale T+3	yes	50	2 years
Corporate Bonds other	AA	Sale T+3	yes	20	2 years
Other debt issuance by UK banks covered by UK Government (explicit) guarantee	UK sovereign rating	Sale T+3	yes	50	2 years

Accounting treatment of investments. The accounting treatment may differ from the underlying cash transactions arising from investment decisions made by this Council. To ensure that the Council is protected from any adverse revenue impact, which may arise from these differences, we will review the accounting implications of new transactions before they are undertaken.

1.6 Other

	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Property funds	--	T+4	yes	50	5 years
Local authority mortgage scheme.	AA			50	5 years

Table 2: permitted investments for use by cash fund managers – Common Good

2.1 Deposits

	Minimum Credit Criteria	**Liquidity risk**	**Market risk**	**Max % of total investments**	**Max. maturity period**
Term deposits – local authorities	--	term	no	100	2 years
Call accounts – banks and building societies	Green	instant	no	100	Call
Term deposits – banks and building societies	Green	term	no	100	2 years
Collateralised deposit	UK sovereign rating	term	no	30	1 year

2.2 Deposits with counterparties currently in receipt of government support / ownership

	*** Minimum Credit Criteria**	**Liquidity risk**	**Market risk**	**Max % of total investments**	**Max. maturity period**
UK part nationalised banks	Blue	Term or instant	no	100	1 year
Banks part nationalised by high credit rated (sovereign rating) countries – non UK	AA+	Term or instant	no	100	1 year
Government guarantee (explicit) on ALL deposits by high credit rated (sovereign rating) countries	Sovereign	Term or instant	no	100	1 year

If forward deposits are to be made, the forward period plus the deal period should not exceed one year in aggregate.

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

	*** Minimum Credit Criteria**	**Liquidity risk**	**Market risk**	**Max % of total investments**	**Max. maturity period**
1. Government Liquidity Funds	AAA	instant	No see note A	20	1 year
2. Money Market Funds	AAA	instant	No see note A	20	1 year
3. Enhanced cash funds	AAA	T+>1	yes	20	1 year
4. Gilt Funds	AAA	T+>1	yes	20	1 year
5. Bond Funds	AAA	T+>1	yes	20	1 year

Note A: the objective of this fund to maintain the net asset value but they hold assets which can vary in value. However, the credit rating agencies require the fluctuation in unit values held by investors to vary by almost zero.

2.4 Securities issued or guaranteed by governments

	Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Treasury Bills	UK sovereign rating	Sale T+1	yes	20	1 year
UK Government Gilts	UK sovereign rating	Sale T+1	yes	20	1 year
Bond issuance issued by a financial institution which is explicitly guaranteed by the UK Government (refers solely to GEFCO - Guaranteed Export Finance Corporation)	UK sovereign rating	Sale T+3	yes	20	1 year
Sovereign bond issues (other than the UK govt)	AAA	Sale T+1	yes	20	1 year
Bonds issued by multilateral development banks	AAA	Sale T+1	yes	20	1 year

2.5 Securities issued by corporate organisations

	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Certificates of deposit issued by banks and building societies covered by UK Government (explicit) guarantee	UK sovereign rating	Sale T+1	yes	50	2 year
Certificates of deposit issued by banks and building	AA	Sale T+1	yes	50	2 years
Commercial paper issuance covered by a specific UK Government (explicit) guarantee	UK sovereign rating	Sale T+1	yes	20	2 years
Commercial paper other	AA	Sale T+1	yes	20	2 years
Corporate Bonds issuance covered by UK Government (implicit) guarantee	UK sovereign rating	Sale T+3	yes	50	2 years
Corporate Bonds other	AA	Sale T+3	yes	20	2 year
Other debt issuance by UK banks covered by UK Government (explicit) guarantee	UK sovereign rating	Sale T+3	yes	50	2 years
Floating Rate Notes	AA	Sale T+1	yes	20	2 years

Accounting treatment of investments. The accounting treatment may differ from the underlying cash transactions arising from investment decisions made by this Council. To ensure that the Council is protected from any adverse revenue impact, which may arise from these differences, we will review the accounting implications of new transactions before they are undertaken.

5.4 APPENDIX: Treasury Management Practice (TMP1) – Credit and Counterparty Risk Management

Argyll and Bute Council and Common Good Funds Permitted Investments, Associated Controls and Limits

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good 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.
b. Deposits with other local authorities or public bodies **(Very low risk)**	These are considered quasi UK Government debt and as such counterparty risk is very low, and there is no risk to value. Liquidity may present a problem as deposits can only be broken with the agreement of the counterparty, and penalties can apply. Deposits with other non-local authority bodies will be restricted to the overall credit rating criteria.	Little mitigating controls required for local authority deposits, as this is a quasi UK Government investment. Non- local authority deposits will follow the approved credit rating criteria.	£unlimited, maximum 1 year.	£unlimited, maximum 1 year.
c. Money Market Funds (MMFs) **(Very low risk)**	Pooled cash investment vehicle which provides very low counterparty, liquidity and market risk. These will primarily be used as liquidity instruments.	Funds will only be used where the MMFs are Constant Net Asset Value (CNAV), and the fund has a “AAA” rated status from either Fitch, Moody’s or Standard and Poor’s.	£10m	100%

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good Limits
d. Call account deposit accounts with financial institutions (banks and building societies) **(Low risk depending on credit rating)**	These tend to be low risk investments, but will exhibit higher risks than categories (a), (b) and (c) above. Whilst there is no risk to value with these types of investments, liquidity is high and investments can be returned at short notice.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's. The selection defaults to the lowest available credit rating to provide additional risk control measures. On day to day investment dealing with this criteria will be further strengthened by the use of additional market intelligence.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.
e. Term deposits with financial institutions (banks and building societies) **(Low to medium risk depending on period & credit rating)**	These tend to be low risk investments, but will exhibit higher risks than categories (a), (b) and (c) above. Whilst there is no risk to value with these types of investments, liquidity is low and term deposits can only be broken with the agreement of the counterparty, and penalties may apply.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's. The selection defaults to the lowest available credit rating to provide additional risk control measures. On day to day investment dealing with this criteria will be further strengthened by the use of additional market intelligence.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good Limits
f. 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.	£10, maximum 1 year.	100%, maximum 1 years.
g. Certificates of deposits with financial institutions **(Low risk)**	These are short dated marketable securities issued by financial institutions and as such counterparty risk is low, but will exhibit higher risks than categories (a), (b) and (c) above. There is risk to value of capital loss arising from selling ahead of maturity if combined with an adverse movement in interest rates. Liquidity risk will normally be low.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's. The selection defaults to the lowest available credit rating to provide additional risk control measures. On day to day investment dealing with this criteria will be further strengthened by the use of additional market intelligence.	£5m, maximum 1 year.	20%, maximum 1 year.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good Limits
h. Structured deposit facilities with banks and building societies (escalating rates, de-escalating rates etc.) **(Low to medium risk depending on period & credit rating)**	These tend to be medium to low risk investments, but will exhibit higher risks than categories (a), (b) and (c) above. Whilst there is no risk to value with these types of investments, liquidity is very low and investments can only be broken with the agreement of the counterparty (penalties may apply).	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's. The selection defaults to the lowest available credit rating to provide additional risk control measures. On day to day investment dealing with this criteria will be further strengthened by the use of additional market intelligence.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.
i. Corporate bonds **(Medium to high risk depending on period & credit rating)**	These are marketable securities issued by financial and corporate institutions. Counterparty risk will vary and there is risk to value of capital loss arising from selling ahead of maturity if combined with an adverse movement in interest rates. Liquidity risk will be low.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's. The selection defaults to the lowest available credit rating to provide additional risk control measures. Corporate bonds will be restricted to those meeting the base criteria. On day to day investment dealing with this criteria will be further strengthened by the use of additional market intelligence.	£1m, maximum 1 year.	20%, maximum 1 year.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good Limits
Other types of investments				
j. Investment properties	These are non-service properties which are being held pending disposal or for a longer term rental income stream. These are highly illiquid assets with high risk to value (the potential for property prices to fall or for rental voids).	In larger investment portfolios some small allocation of property based investment may counterbalance/compliment the wider cash portfolio. Property holding will be re-valued regularly and reported annually with gross and net rental streams.	£20m	20%.
k. 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.	£10m, maximum 5 years.	10% maximum 5 years.
l. 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.	50%.	20%.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good Limits
m. Non-local authority shareholdings	These are non-service investments which may exhibit market risk, be only considered for longer term investments and will be likely to be liquid.	Any non-service equity investment will require separate Member approval and each application will be supported by the service rational behind the investment and the likelihood of loss.	5%.	100%.
n. Loans to third parties as part of the Council's Empty Homes Strategy	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 Head of Strategic Finance approval and each application is supported by the service rational behind the loan and the likelihood of partial or full default. Each funding request will be accompanied by financial projections and be subject to an assessment of the project and borrower.	£1.5m and a maximum of 10 years.	
o. Loans to third parties as part of the Council's SHF Front Funding Facility	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 Head of Strategic Finance approval and each application is supported by the service rational behind the loan and the likelihood of partial or full default. Each funding request will be accompanied by financial projections and be subject to an assessment of the project and borrower.	£5m and a maximum of 3 years.	
p. Loans to third parties as part of the Council's Long Term Loan Funding to RSL's	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 Head of Strategic Finance approval and each application is supported by the service rational behind the loan and the likelihood of partial or full default. Each funding	£5m and a maximum of 30 years.	

		request will be accompanied by financial projections and be subject to an assessment of the project and borrower.		

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

Use of External Fund Managers – It is the Council's plan to use external fund managers for part of its investment portfolio. The fund managers are contractually committed to keep to the Council's investment strategy. The performance of each manager is reviewed at least annually by the Head of Strategic Finance and the managers are contractually required to comply with the annual investment strategy.

5.5 APPENDIX: Approved Countries for Investments

Based on lowest available rating

AAA

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

AA+

- U.K.
- France
- Hong Kong
- U.S.A.

5.6 APPENDIX: Treasury Management Scheme of Delegation

(i) The Council

- receiving and reviewing reports on treasury management policies, practices and activities;
- approval of annual strategy.
- 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.
- reviewing the treasury management policy and procedures and making recommendations to the responsible body.

(ii) Audit Committee

- Review the overall internal and management control framework related to the treasury function.
- Review internal and external audit reports related to treasury management.
- Review provision in the internal and external audit plans to ensure there is adequate audit coverage of treasury management.
- Monitor progress with implementing recommendations in internal and external audit reports.

5.7 APPENDIX: The Treasury Management Role of the Section 95 Officer

The Head of Strategic Finance:-

- recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance;
- submitting regular treasury management policy reports;
- submitting budgets and budget variations;
- receiving and reviewing management information reports;
- reviewing the performance of the treasury management function;
- ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function;
- ensuring the adequacy of internal audit, and liaising with external audit;
- recommending the appointment of external service providers.
- reviewing and considering risk management in terms of treasury activities.

The nominated Elected Member (Lead Councillor for Finance):-

- acting as spokesperson for treasury management.
- taking a lead for elected members in overseeing the operation of the treasury function.
- review the treasury management policy, strategy and reports.
- support and challenge the development of treasury management.

5.8 APPENDIX: Treasury Management Policy Statement

1. This organisation defines its treasury management activities as: “The management of the authority’s investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks”.

2. This organisation regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation, and any financial instruments entered into to manage these risks.

3. This organisation acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance measurement techniques, within the context of effective risk management.”

The policy in respect of borrowing and investments is to minimise the cost of borrowing and maximise investment returns commensurate with the mitigation of risk.