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**TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY**

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**1. EXECUTIVE SUMMARY**

- 1.1 The Council has adopted the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management in Local Authorities. A requirement of the Code is for an annual Treasury Management Strategy Statement and Investment Strategy to be approved by Council for the forthcoming financial year. This report seeks Member's approval of the proposed Treasury Management Strategy Statement and Annual Investment Strategy. The report also sets out the policy for the repayment of loans fund advances for 2019-20 and 2020-21.
- 1.2 The draft Treasury Management Strategy Statement and Annual Investment Strategy will be presented to the:
- Policy and Resources Committee on 20 February 2020
  - Council on 27 February 2020
  - Audit and Scrutiny Committee on 17 March 2020
  - If required, Council on 16 April 2020, following recommendations from the Audit and Scrutiny Committee that need approval from Council.
- 1.3 The Council uses Link Asset Services as its external treasury management advisors. The Council 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 subject to regular review.
- 1.4 Section 2 of the attached document outlines the Council's Capital Prudential and Treasury Indicators which Members are asked to approve.
- 1.5 Section 2.5 notes that, in 2016, new regulations were enacted by the Scottish Parliament, the Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016, under which 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 policy on repayment of loans fund advances in respect of capital expenditure by the Council is to ensure 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.
- 1.6 A variety of repayments options are provided to Councils so long as a prudent provision is made each year and these are summarised in the table below.

Option	Description	Implications
Option 1 – Statutory Method	Loans fund advances will be repaid in equal instalments of principal by the annuity method. The Council is permitted to use this option for a transitional period only, of five years until 31st March 2021, at which time it must change its policy to use alternative approaches based on depreciation, asset life periods or a funding/income profile	This is the current method for repaying advances and is the most predictable for setting budgets.
Option 2 – Depreciation Method	annual repayment of loans fund advances will follow standard depreciation accounting procedures	The repayments are matched to the depreciation charges which means that if the asset was impaired the Council would need to repay an equivalent amount of the outstanding debt, rather than continuing with the scheduled repayments.
Option 3 – 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	The repayments ensure that the debt is repaid over a period that is reasonably commensurate with that over which the capital expenditure provides benefits.
Option 4 – Funding/Income profile method	loans fund advances will be repaid by reference to an associated income stream	Under this methodology the repayment of debt is matched to the income stream from the asset which is suited to spend to save scheme and assets which generate income which is being used to repay the debt outstanding.

- 1.7 A review of the Council's loan fund advance repayments has been undertaken with advice from our Treasury Advisors, Link Asset Services. The review was undertaken to ensure the Council continues to make a prudent provision each year for the repayment of loans fund advances.
- 1.8 The review considered new loans fund advances and historic loans fund advances to assess whether the repayment methodology was still the most prudent option. Data was available for loans fund advances from 2004-05 onwards.
- 1.9 The review also considered the annuity interest rate that is applied to loans funds advances. Under regulation 14 (2) of SSI 2016 No 123, the Council has reviewed and re-assessed the historic annuity rate to ensure that it is a prudent application. The result of this review suggests that a revised annuity rate of 5.1% would provide a fairer and more prudent approach and provide principal repayments more closely associated with the use of the assets.
- 1.10 The Council is recommended to approve the following policy on the repayment of loans fund advances:
- For loans fund advances made before 1 April 2019, the policy will be to maintain the practice of previous years and apply the **Statutory Method**, with all loans fund advances being repaid using a 5.1% annuity rate over an average period of 32 years. For those loans fund advances outstanding at 1 April 2004 a repayment period of 14 years will be used.
  - For loans fund advances made after 1 April 2019:

- **Asset life method** – loans fund advances will be repaid with reference to the life of an asset using a 5.1% annuity rate;
- **Funding / Income profile method** – loans fund advances will be repaid by reference to an associated income stream using a 5.1% annuity rate. This would be utilised where the asset will generate income which can be used to repay the debt or as a result of spend to save schemes where again the savings can be used to repay the loans fund advances.

- 1.11 Further information on the loans fund review to support the recommended policy is included within Loans Fund Review paper included as Appendix 2.
- 1.12 The results of applying the revised methodology to the current outstanding loans fund advances and assumed future advances (based on the current three year capital plan) will give rise to a medium term (5 year) revenue saving in addition to a one-off re-profiling gain in relation to prior year repayments. The one-off re-profiling gain can be taken in future years in any way the authority wishes, as long as it deems it to be prudent and does not result in a negative charge. This means that the gain released each year is limited to the principal repayments in year (currently circa £5m per annum).
- 1.13 It would be prudent to use the one-off re-profiling gain to make a provision for the estimated rise in principal repayments over the next 10 years and to fund the current known and emerging liabilities/cost pressures as outlined within the Revenue Budget Overview Report within the Budget Pack.
- 1.14 Section 3 of the document outlines the current actual external debt against the capital financing requirement highlighting any over or under borrowing. There is information on the interest rates projections and the borrowing strategy.
- 1.15 Section 4 of the document outlines the annual investment strategy. The Council's investment priorities will be security first, liquidity second and then return. It explains the creditworthiness policy and the use of Link Asset Services in this respect as well as the Country and Sector limits.
- 1.16 There are a number of appendices in Section 5. Some of this information has been provided by our Treasury advisors, Link Asset Services.
- 1.17 In September 2019, Council agreed to make two amendments to the Council's 2019/20 Annual Treasury Management Strategy as follows:
- 1) Amend the investment limit for term deposits with the following UK Banks from £10m to £15m:
    - Bank of Scotland PLC
    - Goldman Sachs International Bank
    - Santander UK PLC
  - 2) Amend the maximum duration that a deposit can be made with other local authorities or public bodies from 1 year to 2 years.

These amendments are reflected within the Treasury Management Strategy Statement.

## **2. RECOMMENDATIONS**

2.1 It is recommended that Policy and Resources Committee refer to Council to:

- a) Approve the proposed Treasury Management Strategy Statement and Annual Investment Strategy and the indicators contained within.
- b) Approve the use of the statutory method for the repayment of loan fund advances prior to 1 April 2019 in respect of existing capital expenditure using a 5.1% annuity interest rate over an average period of 32 years. For those loans fund advances outstanding at 1 April 2004 a repayment period of 14 years will be used.
- c) Approve the use of the asset life method for the repayment of loan fund advances after 1<sup>st</sup> April 2019 using a 5.1% annuity interest rate, with the exception of spend to save schemes where the funding/income profile method could be used.
- d) Approve the proposed asset repayment periods as detailed within section 2.6 of the Treasury Management Strategy Statement.
- e) Approve the ability to continue to use countries with a sovereign rating of AA- and above, as recommended by Link Asset Services.

## **3. IMPLICATIONS**

3.1 Policy – Sets the policy for borrowing and investment decisions.

3.2 Financial – Revised methodology gives rise to a revenue saving in addition to a one-off re-profiling gain in relation to prior year repayments. An effective Treasury Management Strategy forms a significant part of the Council's financial arrangements and its financial well-being.

3.3 Legal - None.

3.4 HR - None.

3.5 Fairer Scotland Duty - None.

3.6 Risk - This report does not require any specific risk issues to be addressed, however members will be aware that the management of risk is an integral part of the Council's treasury management activities.

3.7 Customer Service - None.

**Policy Lead for Strategic Finance and Capital Regeneration Projects:  
Councillor Gary Mulvaney**

**Kirsty Flanagan  
Section 95 Officer**

**13 February 2020**

For further information please contact:

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**APPENDICES**

Appendix 1 – Treasury Management Strategy Statement and Annual Investment Strategy 2020-21

Appendix 2 – Loans Fund Review Briefing



**Treasury Management Strategy Statement  
and Annual Investment Strategy 2020-2021**

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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, when it is prudent and economic, any debt previously drawn may be restructured to meet Council risk or cost objectives.

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

Whilst any loans to third parties, commercial investment initiatives or other non-financial investments will impact on the treasury function, these activities are generally classed as non-treasury activities, (arising usually from capital expenditure), and are separate from the day to day treasury management activities.

CIPFA defines treasury management as:

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

Revised reporting is required for the 2020/21 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. Good progress has been made with the Council's capital strategy and it is expected to be presented to Policy and Resources Committee for approval in May 2020.

## 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 policies, estimates and actuals.

An annual Treasury Management Strategy Statement (this report) – this is the first and most important report which is submitted to full Council before the start of the financial year. Prior to submission to full Council, this report is scrutinised by the Audit and Scrutiny Committee. It covers:

- The capital plans (including prudential indicators);



- A policy for the statutory repayment of debt, (how residual capital expenditure is charged to revenue over time);
- The treasury management strategy (how the investments and borrowings are to be organised) including treasury indicators; and
- A permitted investment strategy (the parameters on how investments are to be managed).

A mid-year Treasury Management Review Report - this will update Members with the progress of the capital position, amending prudential indicators as necessary and whether any policies require revision. Monitoring reports are submitted to each Policy and Resources Committee.

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.

## **Capital Strategy**

The CIPFA revised 2017 Prudential and Treasury Management Codes require all local authorities to prepare a capital strategy report, which will provide the following:

- a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services
- an overview of how the associated risk is managed
- the implications for future financial sustainability.

The aim of this capital strategy is to ensure that all elected members on the full council fully understand the overall long-term policy objectives and resulting capital strategy requirements, governance procedures and risk appetite.

### **1.3 Treasury Management Strategy for 2020/21**

The strategy for 2020/21 covers two main areas:

#### **Capital issues**

- the capital expenditure plans and the associated prudential indicators.
- The loans fund repayment policy.

#### **Treasury management issues**

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

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

## **1.4 Training**

The CIPFA Code requires the responsible officer to ensure that Members with responsibility for treasury management receive adequate training in treasury management. This especially applies to Members responsible for scrutiny (Audit and Scrutiny Committee).

The training needs of treasury management officers are periodically reviewed.

## **1.5 Treasury management advisors**

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

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

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

## 2 CAPITAL PRUDENTIAL AND TREASURY INDICATORS 2020/21 – 2022/23

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

### 2.1 Capital Expenditure and Financing

This prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of the 2020/21 budget setting.

The table below summarises the capital expenditure plans as outlined within the proposed capital plan 2020-23.

Capital Expenditure £'000	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
<b>Executive Director - Douglas Hendry</b>					
Education	10,914	8,732	9,603	2,949	2,920
Facility Services - Shared Offices	743	1,926	1,500	725	561
Major Projects/CHORD	8,251	7,078	9,489	7,352	1,462
<b>Executive Director - Kirsty Flanagan</b>					
ICT	1,515	909	1,011	1,011	1,011
Roads and Infrastructure	13,162	14,634	18,185	19,555	20,467
Development and Economic Growth	1,833	2,600	494	0	0
<b>Live Argyll</b>	464	1,082	396	563	561
<b>Health and Social Care Partnership</b>	90	782	895	536	561
<b>Total</b>	<b>36,972</b>	<b>37,743</b>	<b>41,573</b>	<b>32,691</b>	<b>27,543</b>

The table below summarises the above capital expenditure plans and how capital or revenue resources are financing them. Any shortfall of resources results in a funding borrowing need. (The financing need excludes other long-term liabilities, such as PFI and leasing arrangements, which already include borrowing instruments.)

Capital Expenditure £'000	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
<b>Total Capital Expenditure</b>	36,972	37,743	41,573	32,691	27,543
<b>Financed by:</b>					
Capital Receipts	493	1,419	1,202	2,202	1,202
Capital Grants	19,349	14,192	11,502	11,245	11,245
Capital Reserves	0	0	0	0	0
Revenue	575	22,836	9,680	5,000	0
<b>Net Financing need for the year</b>	<b>16,555</b>	<b>(704)</b>	<b>19,189</b>	<b>14,244</b>	<b>15,096</b>

## 2.2 The Council's Overall 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 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, called the Loan Fund Principal Repayment, which reflect the useful life of capital assets financed by borrowing. This charge reduces the CFR each year. From 1 April 2016, authorities may choose whether to use scheduled debt amortisation, (loans pool charges), or another suitable method of calculation in order to repay borrowing.

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 £129.8m of such schemes within the CFR.

The CFR projections are noted in the following table.

£'000	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
<b>Capital Financing Requirement</b>					
Opening CFR	306,433	309,994	298,658	307,668	310,813
Closing CFR	309,994	298,658	307,668	310,813	313,961
<b>Movement in CFR</b>	<b>3,561</b>	<b>(11,336)</b>	<b>9,010</b>	<b>3,145</b>	<b>3,148</b>
<b>Movement in CFR represented by</b>					
Net financing need for the year (above)	16,555	(704)	19,189	14,244	15,096
Less scheduled debt Amortisation	12,994	10,632	10,179	11,099	11,948
<b>Movement in CFR</b>	<b>3,561</b>	<b>(11,336)</b>	<b>9,010</b>	<b>3,145</b>	<b>3,148</b>

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 2.1 and the details above demonstrate the scope of this activity and, by approving these figures, consider the scale proportionate to the Council's remaining activity.

## 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 balances for each resource and anticipated day-to-day cash flow balances.

Year End Resources £'000	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
Expected Investments	71,332	64,500	50,000	40,000	30,000

## 2.4 Limits to Borrowing Activity

**The operational boundary:** This is the limit beyond which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt and the ability to fund under-borrowing by other cash resources.

Operational Boundary £'m	2018/19 Actual	2019/20 Actual	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
Debt	194	200	200	210	207
Other long term liabilities	128	124	124	119	114
<b>Total</b>	<b>322</b>	<b>324</b>	<b>324</b>	<b>329</b>	<b>321</b>

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

- a) The authorised limits for external debt for the current year and two subsequent years are the legislative limits determined under Regulation 6(1) of the Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016.
- b) The Council is asked to approve the following authorised limit:

Authorised Limit £'m	2018/19 Actual	2019/20 Actual	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
Debt	199	205	205	215	212
Other long term liabilities	131	127	127	122	117
<b>Total</b>	<b>330</b>	<b>332</b>	<b>332</b>	<b>337</b>	<b>329</b>

## 2.5 Statutory repayment of loans fund advances

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

A variety of options are provided to Councils so long as a prudent provision is made each year. A review of the Council's loan fund advances has been undertaken to ensure the Council continues to make a prudent provision each year for the repayment of loans fund advances.

The majority of the loans outstanding at 1 April 2004 had a remaining life of between 1-19 years. Further analysis confirmed that the average remaining life for loans fund advances outstanding at 1 April 2004 was 14 years and it is suggested that a repayment period of 14 years is used for these loans fund advances. The review of historic debt from the period between 2004-05 and 2018-19 indicates the average repayment period should be 32 years using the annuity method.

The Council is recommended to approve the following policy on the repayment of loans fund advances:

For loans fund advances made before 1 April 2019, the policy will be to maintain the practice of previous years and apply the **Statutory Method**, with all loans fund advances being repaid using a 5.1% annuity rate over an average period of 32 years. For those loans fund advances outstanding at 1 April 2004 a repayment period of 14 years will be used.

For loans fund advances made after 1 April 2019, 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 a 5.1% annuity rate;
2. **Funding / Income profile method** – loans fund advances will be repaid by reference to an associated income stream.

The annuity rate applied to the loans fund repayments was based on historic interest rates and is currently 3.79%. However, under regulation 14 (2) of SSI 2016 No 123, the Council has reviewed and re-assessed the historic annuity rate to ensure that it is a prudent application. The result of this review suggests that a revised annuity rate of 5.1% would provide a fairer and more prudent approach and provide principal repayments more closely associated with the use of the assets.

## 2.6 Asset Repayment Periods

Using the asset life method, the Council is required to ensure that the debt is repaid over a period that is reasonably commensurate with that over which the capital expenditure provides benefits. In doing so the table below states the repayment period to be used for each asset type.

Asset Type	Repayment Period (Years)
Land (including Cemeteries)	100
Road Structures - Bridges, Retaining Walls, Sea Walls, Flood Defences	60
Piers and Harbours	60
Roads & Footways	20
Street Lighting	30
Vehicles & Plant	7
IT Equipment	5
Major Regeneration Works (Public Realm etc)	60
New Builds including Schools	60
Buildings - Electrical	40
Buildings - Plant	20
Buildings - Roofing	35
Buildings - Windows & External Doors	20
Buildings - Structural	25

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

#### 3.1 Current portfolio position

The Council's treasury portfolio position at 31 March 2019 and at 31 December 2019 are shown below for both borrowing and investments.

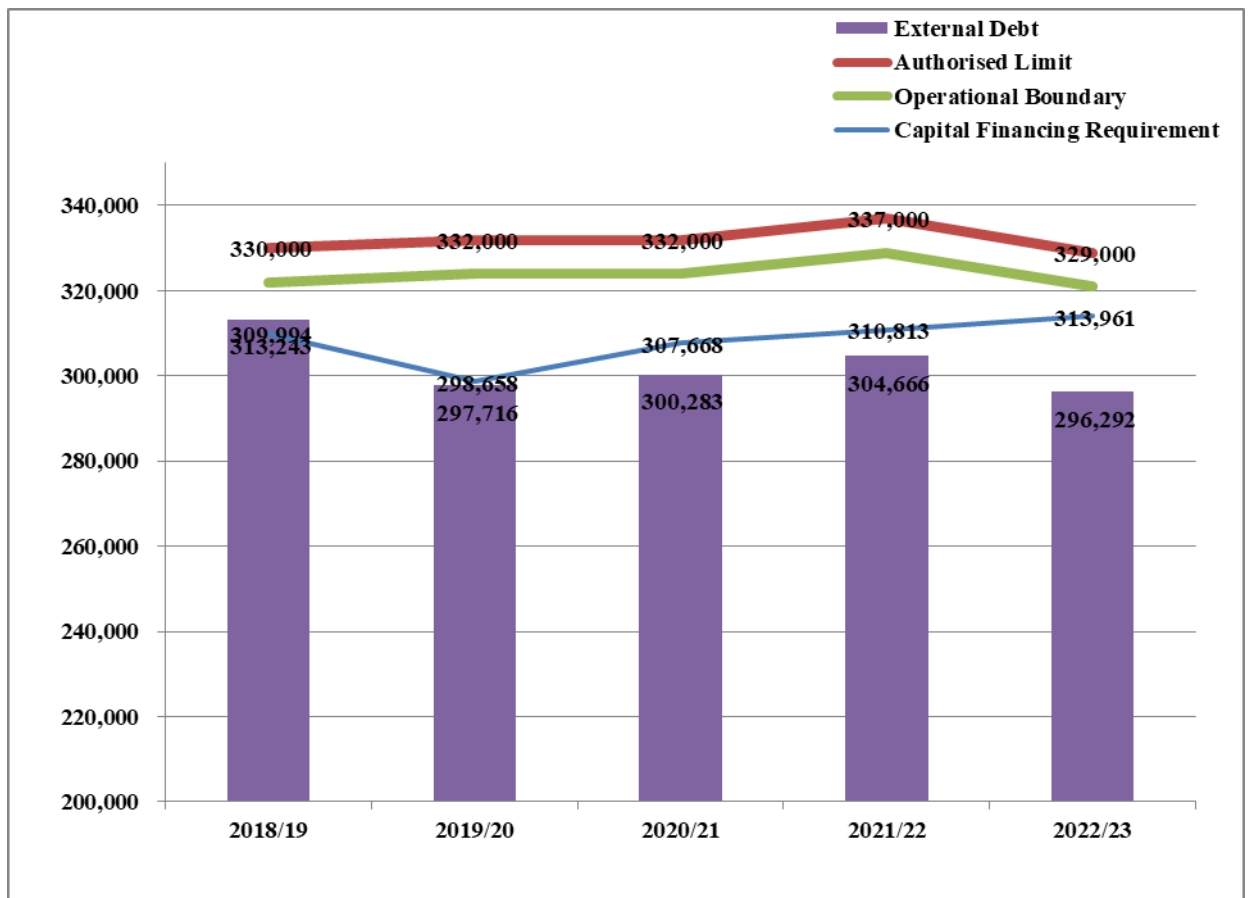
TREASURY PORTFOLIO				
	Actual 31.3.19	Actual 31.3.19	Current 31.12.19	Current 31.12.19
	£000	%	£000	%
<b>Treasury investments</b>				
Banks	43,543	55%	61,821	62%
Building Societies - rated	5,000	6%	0	0%
Local Authorities	0	0%	17,000	17%
Money Market Funds	16,500	21%	11,500	12%
Certificates of Deposit	10,000	13%	5,000	5%
Third Party Loans	4,346	5%	4,253	4%
<b>Total managed in house</b>	<b>79,389</b>	<b>100%</b>	<b>99,574</b>	<b>100%</b>
Bond Funds	0	0%	0	0%
Property Funds	0	0%	0	0%
<b>Total managed externally</b>	<b>0</b>	<b>0%</b>	<b>0</b>	<b>0%</b>
<b>Total Treasury Investments</b>	<b>79,389</b>	<b>100%</b>	<b>99,574</b>	<b>100%</b>
<b>Treasury external borrowing</b>				
PWLB	127,337	71%	124,843	68%
LOBOs	39,255	22%	39,255	21%
Market	11,000	6%	11,000	6%
Special	214	0%	256	0%
Temporary Borrowing	574	0%	8,089	4%
Local Bonds	33	0%	33	0%
<b>Total External Borrowing</b>	<b>178,413</b>	<b>100%</b>	<b>183,476</b>	<b>100%</b>
<b>Net Treasury Investments / (Borrowing)</b>	<b>(99,024)</b>		<b>(83,902)</b>	

A more detailed analysis of the above table showing actual investments placed with individual counterparties can be found in Appendix 2.

The Council's forward projections for borrowing, 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.

	2018/19	2019/20	2020/21	2021/22	2022/23
£'000	Actual	Estimate	Estimate	Estimate	Estimate
<b>External Debt</b>					
Debt as 1st April	178,488	183,476	173,601	180,741	189,939
Change in Debt (In Year)	4,988	(9,875)	7,140	9,198	(3,277)
Other long-term liabilities (OLTL) at 1st April	128,631	129,767	124,115	119,542	114,727
Change in OLTL (In Year)	1,136	(5,652)	(4,573)	(4,815)	(5,097)
<b>Actual gross debt at 31st March</b>	<b>313,243</b>	<b>297,716</b>	<b>300,283</b>	<b>304,666</b>	<b>296,292</b>
<b>The Capital Financing Requirement</b>	<b>309,994</b>	<b>298,658</b>	<b>307,668</b>	<b>310,813</b>	<b>313,961</b>
<b>Under / (Over) borrowing</b>	<b>(3,249)</b>	<b>942</b>	<b>7,385</b>	<b>6,147</b>	<b>17,669</b>

The following graph shows the the CFR compared to the expected net debt in each of the years and the under / (over) borrowed position, also shown is the Council's authorised limit for debt and it's operational boundary (see paragraph 2.4 above.





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 2020/21 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not taken for revenue or speculative purposes.

The Head of Financial Services 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 Prospects for interest rates

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

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

Link Asset Services have also provided commentary in relation to interest rates and this is included within Appendix 3.

### 3.3 Investment and borrowing rates

Investment returns are likely to remain low during 2020/21 with little increase in the following two years. However, if major progress was made with an agreed UK withdrawal from the EU, then there is upside potential for earnings.

Borrowing interest rates were on a major falling trend during the first half of 2019-20 but then jumped up by 100 bps on 9<sup>th</sup> October 2019. The policy of avoiding new borrowing by running down spare cash balances has served local authorities well over the last few years. However, the unexpected increase of 100 bps in PWLB rates requires a major rethink of local authority treasury management strategy and risk management. Now that the gap between longer term borrowing rates and investment rates has materially widened, and in the long term Bank Rate is not expected to rise above 2.5%, it is unlikely that this authority will do any further longer term borrowing for the next three years, or until such time as the extra 100 bps margin is removed

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

### 3.4 Borrowing strategy

Over the past few years, the Council has benefited from lower borrowing costs due to low interest rates, in particular utilisation of short term temporary borrowing and internal borrowing (use of existing cash).

The Council is currently anticipating an under-borrowed position as at the end of 2019/20. 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.

Against this background and the risks within the economic forecast, caution will be adopted with the 2020/21 treasury operations. Any decisions will be reported to the appropriate committee at the next available opportunity. In normal circumstances the main sensitivities of the forecast are likely to be the two scenarios noted below. The Head of Financial Services, in conjunction with the treasury advisors, will continually monitor both the prevailing interest rates and the market forecasts, adopting 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 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.

### **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 sum borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

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

### **3.6 Debt rescheduling**

Rescheduling of current borrowing in our debt portfolio is unlikely to occur as the 100 bps increase in PWLB rates only applied to new borrowing rates and not to premature debt repayment rates.

If rescheduling was done, it will be reported to the appropriate Committee at the earliest meeting following its action.

## 4 ANNUAL INVESTMENT STRATEGY

### 4.1 Investment policy

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

The above regulations and guidance place a high priority on the management of risk. **The Council's investment priorities will be security first, liquidity second and then return.** This authority has adopted a prudent approach to managing risk and defines its risk appetite by the following means:

1. Minimum acceptable credit criteria are applied in order to generate a list of highly creditworthy counterparties. This also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the short term and long-term ratings.
2. Other information: ratings will not be the sole determinant of the quality of an institution; it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To achieve this consideration the Council will engage with its advisors to maintain a monitor on market pricing such as "credit default swaps" and overlay that information on top of the credit ratings.
3. Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.
4. This authority has defined the list of types of investment instruments that are permitted investments authorised for use in Appendix 5. Appendix 6 expands on the risks involved in each type of investment and the mitigating controls.
5. Lending limits, (amounts and maturity), for each counterparty will be set through applying the matrix table in Appendix 7.
6. Transaction limits are set for each type of investment in Appendix 5.
7. This authority will set a limit for the amount of its investments which are invested for **longer than 365 days**, (see paragraph 4.5).
8. Investments will only be placed with counterparties from countries with a specified minimum **sovereign rating**, (see paragraph 4.3).
9. All investments will be denominated in **sterling**.
10. As a result of the change in accounting standards for 2019/20 under **IFRS 9**, this authority will consider the implications of investment instruments which could result in an adverse movement in the value of the amount invested and resultant charges at the end of the year to the General Fund.

However, 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 4.4). Regular monitoring of investment performance will be carried out during the year.

## 4.2 Creditworthiness policy

The Council recognises the vital importance of credit-worthiness checks on the counterparties it uses for investments.

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 further 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.

Further explanation of the approach for creditworthiness used by Link Asset Services is found in Appendix 7.

### UK banks – ring fencing

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 in. Several banks are very close to the threshold already and so may come into scope in the future regardless.

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

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

## 4.3 Country and sector limits

The Council has determined that it will only use approved counterparties from the UK and from countries with a minimum sovereign credit rating of AA- from Fitch. The list of countries that qualify using this credit criteria as at the date of this report are shown in Appendix 8. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

## 4.4 Investment strategy

**In-house funds:** Investments will 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 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**

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

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

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

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

The overall balance of risks to economic growth in the UK is probably to the downside due to the weight of all the uncertainties over the UK's withdrawal from the EU, as well as a softening global economic picture.

The balance of risks to increases in Bank Rate and shorter term PWLB rates are broadly similar to the downside.

### **Investment treasury indicator and limit**

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:

<b>Maximum principal sums invested for longer than 365 days</b>			
<b>£m</b>	<b>2020/21</b>	<b>2021/22</b>	<b>2022/23</b>
Principal sums invested for longer than 365 days	20	20	20

For its cash flow generated balances, the Council will seek to utilise its business reserve instant access and notice accounts, money market funds and short-dated deposits (overnight to 100 days).

#### **4.6 Investment risk benchmarking**

This Council will use an investment benchmark to assess the investment performance of its investment portfolio of 7 day LIBID uncompounded.

#### **4.7 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.

## 5 APPENDICES

### Appendix 1 – Capital Prudential and Treasury Indicators 2019/20 – 2021/22

#### 1. 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:

##### 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.

	2018/19	2019/20	2020/21	2021/22	2022/23
%	Actual	Estimate	Estimate	Estimate	Estimate
Ratio	7.08%	5.93%	5.83%	5.84%	5.89%

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

#### 2. Maturity structure of borrowing

The purpose of this indicator is 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 this is set to be too restrictive it will impair the opportunities to reduce costs/ improve performance. The indicator is "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 indicator and limits.

Maturity structure of fixed interest rate borrowing 2020/21		
	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 to 20 years	0%	100%
20 years to 30 years	0%	100%
30 years to 40 years	0%	100%
40 years to 50 years	0%	100%

<b>Maturity structure of variable interest rate borrowing 2020/21</b>		
	<b>Lower</b>	<b>Upper</b>
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%	30%
10 years to 20 years	0%	30%
20 years to 30 years	0%	30%
30 years to 40 years	0%	30%
40 years to 50 years	0%	30%

The interest rate exposure in respect of the Council's external debt will be monitored on an ongoing basis by keeping the proportion of variable interest rate debt at an appropriate level given the total amount of external debt and the interest rate environment within which the Council is operating. When interest rates are increasing the Council will look to move to fixed rate borrowing and if interest rates are likely to fall then the level of variable rate borrowing will be increased to minimise future interest payments.



## Appendix 2 – Detailed Current Portfolio Position

TREASURY PORTFOLIO					
		Actual 31.3.19	Actual 31.3.19	Current 31.12.19	Current 31.12.19
Treasury investments		£000	%	£000	%
Banks	Clydesdale Bank	1,043	1%	6,821	7%
	Bank of Scotland	5,000	6%	12,500	13%
	Goldman Sachs	2,500	3%	10,000	10%
	Qatar National Bank	7,500	9%	7,500	8%
	Commonwealth Bank of Australia	5,000	6%		0%
	Santander	0	0%	10,000	10%
	ANZ Banking Group/London	7,500	9%	7,500	8%
	Bayerische Landesbank	5,000	6%		0%
	DBS Bank	5,000	6%		0%
	First Abu Dhabi Bank	5,000	6%	7,500	8%
		43,543	55%	61,821	62%
Building Societies - rated	Nationwide Building Society	5,000	6%	0	0%
Local Authorities	Cherwell District Council	0	0%	5,000	5%
	Lancashire County Council	0	0%	7,000	7%
	Thurrock Borough Council	0	0%	5,000	5%
		0	0%	17,000	17%
Money Market Funds	Aberdeen Liquidity Sterling Fund Class L1	0	0%	4,000	4%
	BNP Paribas Inticast Fund	0	0%	7,500	8%
	Federated	3,000	4%	0	0%
	CCLA	6,000	8%	0	0%
	AVIVA	7,500	9%	0	0%
		16,500	21%	11,500	12%
Certificates of Deposit	Royal Bank of Scotland	5,000	6%	0	0%
	National Westminster Bank Plc	5,000	6%	5,000	5%
		10,000	13%	5,000	5%
Third Party Loans	Argyll Community Housing Association	2,674	3%	2,611	3%
	Fyne Homes	186	0%	182	0%
	West Highland Housing Association Ltd	921	1%	901	1%
	The Port Ellen Station	73	0%	67	0%
	Hubco Sub Debt	492	1%	492	0%
		4,346	5%	4,253	4%
Total Treasury Investments		79,389	100%	99,574	100%

		Actual 31.3.19	Actual 31.3.19	Current 31.12.19	Current 31.12.19
<b>Treasury external borrowing</b>					
Local Authorities		0	0%	0	0%
PWLB		127,337	71%	124,843	68%
LOBOs	Commerzbank Finance & Covered Bonds S.A.	13,000	7%	13,000	7%
	FMS Wertmanagement	5,255	3%	5,255	3%
	Bayerische Landesbank	21,000	12%	21,000	11%
		39,255	22%	39,255	21%
Market	Barclays (formerly LOBO)	10,000	6%	10,000	5%
	Prudential assurance co	1,000	1%	1,000	1%
		11,000	6%	11,000	6%
Special	Prudential assurance co	14	0%	16	0%
	Salix Finance Ltd	200	0%	240	0%
		214	0%	256	0%
Temporary Borrowing		574	0%	8,089	4%
Local Bonds		33	0%	33	0%
<b>Total External Borrowing</b>		<b>178,413</b>	<b>100%</b>	<b>183,476</b>	<b>100%</b>

### Appendix 3 – Interest Rate Forecasts 2020 - 2023 and Commentary Provided by Link Asset Services (at 17.01.20)

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

The above interest rate forecasts, provided by Link Asset Services, are **predicated on an assumption of an agreement being reached regarding the UK's withdrawal from the EU**. On this basis, while GDP growth is likely to be subdued in 2019 and 2020 due to all the uncertainties around the UK's withdrawal from the EU depressing consumer and business confidence, an agreement on the detailed terms of a trade deal is likely to lead to a boost to the rate of growth in subsequent years. This 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 in December 2020**, 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 were a **disorderly withdrawal of the UK from the EU**, then any cut in Bank Rate would be likely to last for a longer period and also depress short and medium gilt yields correspondingly. Quantitative easing could also be restarted by the Bank of England. It is also possible that the government could act to protect economic growth by implementing fiscal stimulus.

#### **The balance of risks to the UK:**

- The overall balance of risks to economic growth in the UK is probably even, but dependent on a successful outcome of negotiations on a trade deal.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates are broadly similarly to the downside.
- In the event that a deal was agreed with the EU and approved by Parliament, the balance of risks to economic growth and to increases in Bank Rate is likely to change to the upside.

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 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:**

- **UK withdrawal from EU** – if it were to cause significant economic disruption and a major downturn in the rate of growth.
- **Bank of England** 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**. In 2018, Italy was a major concern due to having a populist coalition government which made a lot of anti-austerity and anti-EU noise. However, in September 2019 there was a major change in the coalition governing Italy which has brought to power a much more EU friendly

government; this has eased the pressure on Italian bonds. Only time will tell whether this new coalition based on an unlikely alliance of two very different parties will endure.

- Weak capitalisation of some **European banks**, particularly Italian banks.
- **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. The CDU has done badly in recent state elections but the SPD has done particularly badly and this has raised a major question mark over continuing to support the CDU. Angela Merkel has stepped down from being the CDU party leader but she intends to remain as Chancellor until 2021.
- **Other minority EU governments.** Austria, Finland, Sweden, Spain, Portugal, Netherlands and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Austria, the Czech Republic, Poland and Hungary** now form a strongly anti-immigration bloc within the EU. There has also been rising anti-immigration sentiment in Germany and France.
- In October 2019, the IMF issued a report on the World Economic Outlook which flagged up a synchronised slowdown in world growth. However, it also flagged up that there was **potential for a rerun of the 2008 financial crisis**, but this time centred on the huge debt binge accumulated by corporations during the decade of low interest rates. This now means that there are corporates who would be unable to cover basic interest costs on **some \$19trn of corporate debt in major western economies**, if world growth was to dip further than just a minor cooling. This debt is mainly held by the shadow banking sector i.e. pension funds, insurers, hedge funds, asset managers etc., who, when there is \$15trn of corporate and government debt now yielding negative interest rates, have been searching for higher returns in riskier assets. Much of this debt is only marginally above investment grade so any rating downgrade could force some holders into a fire sale, which would then depress prices further and so set off a spiral down. The IMF's answer is to suggest imposing higher capital charges on lending to corporates and for central banks to regulate the investment operations of the shadow banking sector. In October 2019, the deputy Governor of the Bank of England also flagged up the dangers of banks and the shadow banking sector lending to corporates, especially highly leveraged corporates, which had risen back up to near pre-2008 levels.
- **Geopolitical risks**, for example in 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:**

- **UK withdrawal from EU** – if agreement was reached all round that removed all threats of economic and political disruption between the EU and the UK.
- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary 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.

## Appendix 4 – Economic Background Provided by Link Asset Services (at 03.01.20)

**UK withdrawal from EU.** 2019 has been a year of upheaval on the political front as Theresa May resigned as Prime Minister to be replaced by Boris Johnson on a platform of the UK leaving the EU on 31 October 2019, with or without a deal. However, MPs blocked leaving on that date and the EU agreed an extension to 31 January 2020. In late October, MPs approved an outline of a deal to enable the UK to leave the EU on 31 January. Now that the Conservative Government has gained a large overall majority in the **general election** on 12 December, this outline deal will be passed by Parliament by that date. However, there will still be much uncertainty as the detail of a trade deal will need to be negotiated by the current end of the transition period in December 2020, which the Prime Minister has pledged he will not extend. This could prove to be an unrealistically short timetable for such major negotiations that leaves open two possibilities; one, the need for an extension of negotiations, probably two years, or, a no deal in December 2020.

**GDP growth** has taken a hit from uncertainty surrounding the UK's withdrawal from the EU during 2019; quarter three 2019 surprised on the upside by coming in at +0.4% q/q, +1.1% y/y. However, the peak of uncertainty during the final quarter appears to have suppressed quarterly growth to probably around zero. The economy is likely to tread water in 2020, with tepid growth around about 1% until there is more certainty after the trade deal deadline is passed.

While the Bank of England went through the routine of producing another **quarterly Inflation Report**, (now renamed the Monetary Policy Report), on 7 November, it is very questionable how much all the writing and numbers were worth when faced with the uncertainties of where the UK will be after the general election. The Bank made a change in their assumptions surrounding the UK's withdrawal from the EU to now include a deal being eventually passed. Possibly the biggest message that was worth taking note of from the Monetary Policy Report, was an increase in concerns among MPC members around weak global economic growth and the potential for uncertainties to become entrenched and so delay UK economic recovery. Consequently, the MPC voted 7-2 to maintain Bank Rate at 0.75% but two members were sufficiently concerned to vote for an immediate Bank Rate cut to 0.5%. The MPC warned that if global growth does not pick up or uncertainties intensify, then a rate cut was now more likely. Conversely, if risks do recede, then a more rapid recovery of growth will require gradual and limited rate rises. The speed of recovery will depend on the extent to which uncertainty dissipates over the final terms for trade between the UK and EU and by how much global growth rates pick up. The Bank revised its inflation forecasts down – to 1.25% in 2019, 1.5% in 2020, and 2.0% in 2021; hence, the MPC views inflation as causing little concern in the near future.

The **MPC meeting of 19 December** repeated the previous month's vote of 7-2 to keep Bank Rate on hold. Their key view was that there was currently 'no evidence about the extent to which policy uncertainties among companies and households had declined' i.e. they were going to sit on their hands and see how the economy goes in the next few months. The two members who voted for a cut were concerned that the labour market was faltering. On the other hand, there was a clear warning in the minutes that the MPC were concerned that "domestic unit labour costs have continued to grow at rates above those consistent with meeting the inflation target in the medium term".

If economic growth were to weaken considerably, the MPC has relatively little room to make a big impact with Bank Rate still only at 0.75%. It would therefore, probably suggest that it would be up to the Chancellor to provide help to support growth by way of a **fiscal boost** by e.g. tax cuts, increases in the annual expenditure budgets of government departments and services and expenditure on infrastructure projects, to boost the economy. The Government has already made moves in this direction and it made significant promises in its election

manifesto to increase government spending by up to £20bn p.a., (this would add about 1% to GDP growth rates), by investing primarily in infrastructure. This is likely to be announced in the next Budget, probably in February 2020. The Chancellor has also amended the fiscal rules in November to allow for an increase in government expenditure.

As for **inflation** itself, CPI has been hovering around the Bank of England's target of 2% during 2019, but fell again in both October and November to a three-year low of 1.5%. It is likely to remain close to or under 2% over the next two years and so, it does not pose any immediate concern to the MPC at the current time. However, if there was a hard or no deal withdrawal from the EU, inflation could rise towards 4%, primarily because of imported inflation on the back of a weakening pound.

With regard to the **labour market**, growth in numbers employed has been quite resilient through 2019 until the three months to September where it fell by 58,000. However, there was an encouraging pick up again in the three months to October to growth of 24,000, which showed that the labour market was not about to head into a major downturn. The unemployment rate held steady at a 44-year low of 3.8% on the Independent Labour Organisation measure in October. Wage inflation has been steadily falling from a high point of 3.9% in July to 3.5% in October (3-month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 2.0%. As the UK economy is very much services sector driven, an 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. The other message from the fall in wage growth is that employers are beginning to find it easier to hire suitable staff, indicating that supply pressure in the labour market is easing.

**USA.** President Trump's massive easing of fiscal policy in 2018 fuelled a temporary boost in consumption in that year which generated an upturn in the rate of growth to a robust 2.9% y/y. **Growth** in 2019 has been falling after a strong start in quarter 1 at 3.1%, (annualised rate), to 2.0% in quarter 2 and then 2.1% in quarter 3. The economy looks likely to have maintained a growth rate similar to quarter 3 into quarter 4; fears of a recession have largely dissipated. The strong growth in employment numbers during 2018 has weakened during 2019, indicating that the economy had been cooling, while inflationary pressures were also weakening. However, CPI inflation rose from 1.8% to 2.1% in November, a one year high, but this was singularly caused by a rise in gasoline prices.

**The Fed** finished its series of increases in rates to 2.25 – 2.50% in December 2018. In July 2019, it cut rates by 0.25% as a 'midterm adjustment' but flagged up that this was not intended to be seen as the start of a series of cuts to ward off a downturn in growth. It also ended its programme of quantitative tightening in August, (reducing its holdings of treasuries etc.). It then cut rates by 0.25% again in September and by another 0.25% in its October meeting to 1.50 – 1.75%.. At its September meeting it also said it was going to **start buying Treasuries again**, although this was not to be seen as a resumption of quantitative easing but rather an exercise to relieve liquidity pressures in the repo market. Despite those protestations, this still means that the Fed is again expanding its balance sheet holdings of government debt. In the first month, it will buy \$60bn, whereas it had been reducing its balance sheet by \$50bn per month during 2019. As it will be buying only short-term (under 12 months) Treasury bills, it is technically correct that this is not quantitative easing (which is purchase of long term debt). The Fed left rates unchanged in December. However, the accompanying statement was more optimistic about the future course of the economy so this would indicate that further cuts are unlikely.

Investor confidence has been badly rattled by the progressive ramping up of increases in tariffs President Trump has made on Chinese imports and China has responded with increases in tariffs on American imports. This **trade war** is seen as depressing US, Chinese



and world growth. In the EU, it is also particularly impacting Germany as exports of goods and services are equivalent to 46% of total GDP. It will also impact developing countries dependent on exporting commodities to China.

However, in November / December, progress has been made on agreeing a phase one deal between the US and China to roll back some of the tariffs; this gives some hope of resolving this dispute.

**EUROZONE. Growth** has been slowing from +1.8 % during 2018 to around half of that in 2019. Growth was +0.4% q/q (+1.2% y/y) in quarter 1, +0.2% q/q (+1.2% y/y) in quarter 2 and then +0.2% q/q, +1.1% in quarter 3; there appears to be little upside potential in the near future. German GDP growth has been struggling to stay in positive territory in 2019 and fell by -0.1% in quarter 2; industrial production was down 4% y/y in June with car production down 10% y/y. Germany would be particularly vulnerable to a no deal, depressing exports further and if President Trump imposes tariffs on EU produced cars.

**The European Central Bank (ECB)** ended its programme of quantitative easing purchases of debt in December 2018, which then meant that the central banks in the US, UK and EU had all ended the phase of post financial crisis expansion of liquidity supporting world financial markets by quantitative easing purchases of debt. However, the downturn in EZ growth in the second half of 2018 and into 2019, together with inflation falling well under the upper limit of its target range of 0 to 2%, (but it aims to keep it near to 2%), has prompted the ECB to take new measures to stimulate growth. At its March meeting it said that it expected to leave interest rates at their present levels “at least through the end of 2019”, but that was of little help to boosting growth in the near term. Consequently, it announced a **third round of TLTROs**; this provides banks with cheap borrowing every three months from September 2019 until March 2021 that means that, although they will have only a two-year maturity, the Bank was making funds available until 2023, two years later than under its previous policy. As with the last round, the new TLTROs will include an incentive to encourage bank lending, and they will be capped at 30% of a bank's eligible loans. However, since then, the downturn in EZ and world growth has gathered momentum; at its meeting on 12 September it cut its deposit rate further into negative territory, from -0.4% to -0.5%, and announced a **resumption of quantitative easing purchases of debt for an unlimited period**. At its October meeting it said these purchases would start in November at €20bn per month - a relatively small amount compared to the previous buying programme. It also increased the maturity of the third round of TLTROs from two to three years. However, it is doubtful whether this loosening of monetary policy will have much impact on growth and, unsurprisingly, the ECB stated that governments would need to help stimulate growth by ‘growth friendly’ fiscal policy.

There were no policy changes in the December meeting, which was chaired for the first time by the new President of the ECB, Christine Lagarde. However, the outlook continued to be down beat about the economy; this makes it likely there will be further monetary policy stimulus to come in 2020. She did also announce a thorough review of how the ECB conducts monetary policy, including the price stability target. This review is likely to take all of 2020.

On the political front, Austria, Spain and Italy have been in the throes of **forming coalition governments** with some unlikely combinations of parties i.e. this raises questions around their likely endurance. The latest results of German state elections has put further pressure on the frail German CDU/SDP coalition government and on the current leadership of the CDU. The results of the Spanish general election in November have not helped the prospects of forming a stable coalition.

**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 shadow banking systems. In addition, there still needs to be a greater switch from investment in industrial capacity, property construction and infrastructure to consumer goods production.

**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.

**WORLD GROWTH.** Until recent years, world growth has been boosted by increasing **globalisation** i.e. countries specialising in producing goods and commodities in which they have an economic advantage and which they then trade with the rest of the world. This has boosted worldwide productivity and growth, and, by lowering costs, has also depressed inflation. However, the rise of China as an economic superpower over the last thirty years, which now accounts for nearly 20% of total world GDP, has unbalanced the world economy. The Chinese government has targeted achieving major world positions in specific key sectors and products, especially high tech areas and production of rare earth minerals used in high tech products. It is achieving this by massive financial support, (i.e. subsidies), to state owned firms, government directions to other firms, technology theft, restrictions on market access by foreign firms and informal targets for the domestic market share of Chinese producers in the selected sectors. This is regarded as being unfair competition that is putting western firms at an unfair disadvantage or even putting some out of business. It is also regarded with suspicion on the political front as China is an authoritarian country that is not averse to using economic and military power for political advantage. The current trade war between the US and China therefore needs to be seen against that backdrop. It is, therefore, likely that we are heading into a period where there will be a **reversal of world globalisation and a decoupling of western countries** from dependence on China to supply products. This is likely to produce a backdrop in the coming years of weak global growth and so weak inflation. **Central banks are, therefore, likely to come under more pressure to support growth by looser monetary policy measures and this will militate against central banks increasing interest rates.**

The trade war between the US and China is a major concern to **financial markets** due to the synchronised general weakening of growth in the major economies of the world, compounded by fears that there could even be a recession looming up in the US, though this is probably overblown. These concerns resulted in **government bond yields** in the developed world falling significantly during 2019. If there were a major worldwide downturn in growth, central banks in most of the major economies will have limited ammunition available, in terms of monetary policy measures, when rates are already very low in most countries, (apart from the US). There are also concerns about how much distortion of financial markets has already occurred with the current levels of quantitative easing purchases of debt by central banks and the use of negative central bank rates in some countries. The latest PMI survey statistics of economic health for the US, UK, EU and China have all been predicting a downturn in growth; this confirms investor sentiment that the outlook for growth during the year ahead is weak.

## Appendix 5 - 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.

### Treasury risks

All the investment instruments in tables 1 and 2 are subject to the following risks: -

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

- **Credit and counter-party risk:** this authority has set minimum credit criteria to determine which counterparties and countries are of sufficiently high creditworthiness to be considered for investment purposes. See paragraphs 4.2 and 4.3.
- **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.
- **Market risk:** this authority purchases Certificates of Deposit (CD's), as they offer a higher rate of return than depositing in the DMADF. They are usually held until maturity but in exceptional circumstances, they can be quickly sold at the current market value, (which may vary from the purchase cost), if the need arises for extra cash at short notice. Their value does not usually vary much during their short life.
- **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.
- **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: -

- **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.
- **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 £15m of the total portfolio can be placed with UK banks and £10m in any single non UK bank institution or group at any one time.

## 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'.

### 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.

- **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. The longest period for a term deposit with the DMADF is 6 months.
- **Term deposits with high credit worthiness banks and building societies.** See paragraph 4.2 for an explanation of this authority's definition of high credit worthiness. This is the most widely used form of investing used by local authorities. It offers a much higher rate of return than the DMADF (dependent on term). The authority will ensure diversification of its portfolio of deposits ensuring that no more than £15m of the total portfolio can be placed with any UK bank and £10m with any single non UK bank 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.
- **Call accounts with high credit worthiness banks and building societies.** The objectives are as for term deposits above but there is instant access to recalling cash deposited. This generally means accepting a lower rate of interest than that which could be earned from the same institution by making a term deposit. Some use of call accounts is highly desirable to ensure that the authority has ready access to cash when needed to pay bills.
- **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.
- **Collateralised deposits.** These are deposits placed with a bank which offers collateral backing based on specific assets. Examples seen in the past have included local authority LOBOs, where such deposits are effectively lending to a local authority as that is the ultimate security.

## DEPOSITS WITH COUNTERPARTIES CURRENTLY IN RECEIPT OF GOVERNMENT SUPPORT / OWNERSHIP

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

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

## COLLECTIVE INVESTMENT SCHEMES STRUCTURED AS OPEN ENDED INVESTMENT COMPANIES (OEICS)

- **Government liquidity funds.** These are the same as money market funds (see below) but only invest in government debt issuance with highly rated governments. Due to the higher quality of underlying investments, they offer a lower rate of return than MMFs. However, their net return is typically on a par with the DMADF, but with instant access.
- **Money Market Funds (MMFs).** By definition, MMFs are AAA rated and are widely diversified, using many forms of money market securities including types which this authority does not currently have the expertise or capabilities to hold directly. However, due to the high level of expertise of the fund managers and the huge amounts of money invested in MMFs, and the fact that the weighted average maturity (WAM) cannot exceed 60 days, MMFs offer a combination of high security, instant access to funds, high diversification and good rates of return compared to equivalent instant access facilities. They are particularly advantageous in falling interest rate environments as their 60 day WAM means they have locked in investments earning higher rates of interest than are currently available in the market. MMFs also help an authority to diversify its own portfolio as e.g. a £2m investment placed directly with HSBC is a 100% risk exposure to HSBC whereas £2m invested in a MMF may end up with say £10,000 being invested with HSBC through the MMF. For authorities particularly concerned with risk exposure to banks, MMFs offer an effective way of minimising risk exposure while still getting much better rates of return than available through the DMADF.
- **Ultra short dated bond funds.** These funds are similar to MMFs, can still be AAA rated but have variable net asset values (VNAV) as opposed to a traditional MMF which

has a Constant Net Asset Value (CNAV). They aim to achieve a higher yield and to do this either take more credit risk or invest out for longer periods of time, which means they are more volatile. These funds can have WAM's and Weighted Average Life (WAL's) of 90 – 365 days or even longer. Their primary objective is yield and capital preservation is second. They therefore are a higher risk than MMFs and correspondingly have the potential to earn higher returns than MMFs.

- **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 highly rated government securities. They offer a higher rate of return than investing in the DMADF but they do have an exposure to movements in market prices of assets held.
- **Bond funds.** These can invest in both government and corporate bonds. This therefore entails a higher level of risk exposure than gilt funds and the aim is to achieve a higher rate of return than normally available from gilt funds by trading in non-government bonds.

## 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.

- **Treasury bills.** These are short-term bills, (up to 18 months but usually 9 months or less), issued by the Government and so are backed by the sovereign rating of the UK. The yield is higher than the rate of interest paid by the DMADF and another advantage compared to a time deposit in the DMADF is that they can be sold if there is a need for access to cash at any point in time. However, there is a spread between purchase and sale prices so early sales could incur a net cost during the period of ownership.
- **Gilts.** These are longer-term debt issuance by the UK Government and are backed by the sovereign rating of the UK. The yield is higher than the rate of interest paid by the DMADF and another advantage compared to a time deposit in the DMADF is that they can be sold if there is a need for access to cash at any point in time. However, there is a spread between purchase and sale prices so early sales may incur a net cost. Market movements that occur between purchase and sale may also have an adverse impact on proceeds. The advantage over Treasury bills is that they generally offer higher yields the longer it is to maturity (for most periods) if the yield curve is positive.
- **Bond issuance issued by a financial institution which is explicitly guaranteed by the UK Government** e.g. National Rail. This is similar to a gilt due to the explicit Government guarantee.
- **Sovereign bond issues (other than the UK govt) denominated in Sterling.** As for gilts but issued by other nations. Use limited to issues of nations with at least the same sovereign rating as for the UK.
- **Bonds issued by Multi Lateral Development Banks (MLDBs).** These are similar to c. and e. above but are issued by MLDBs which are typically guaranteed by a group of sovereign states e.g. European Bank for Reconstruction and Development.

## 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 financial institutions). They are negotiable instruments, so can be sold ahead of maturity and also purchased after they have been issued. However, that liquidity can come at a price, where the yield could be marginally 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 financial institution, 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.

## OTHER

**Property fund.** This is a collective investment fund specialising in property. Rather than owning a single property with all the risk exposure that means to one property in one location rising or falling in value, maintenance costs, tenants actually paying their rent / lease etc, a collective fund offers the advantage of diversified investment over a wide portfolio of different properties. This can be attractive for authorities who want exposure to the potential for the property sector to rise in value. However, timing is critical to entering or leaving this sector at the optimum times of the property cycle of rising and falling values. Typically, the minimum investment time horizon for considering such funds is at least 3-5 years.

**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 / colour banding	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Debt Management Agency Deposit Facility	--	term	no	100	6 months
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 (see note 1)	UK sovereign rating	term	no	50	1 year

*Note 1. As collateralised deposits are backed by e.g. AAA rated local authority LOBOs, this investment instrument is effectively a AAA rated investment*

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

	* Minimum Credit Criteria / colour banding	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
UK part nationalised banks	Blue	term	no	100	1 Year
Banks part nationalised by high credit rated (sovereign rating) countries – non UK	UK Sovereign Rating	term	no	100	1 Year
Fixed term deposits with variable rate and variable maturities: - Structured deposits	Green	term	yes	100	1 Year



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

	* Minimum Fund Rating	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
1. Government Liquidity Funds	AAA	instant	No see note 1	100	1 Year
2a. Money Market Funds CNAV	AAA	instant	No see note 1	100	1 Year
2b. Money Market Funds LVNAV	AAA	Instant to T+5	No see note 1	100	1 Year
2c. Money Market Funds VNAV	AAA	instant to T+5	No see note 1	100	1 Year
3. Ultra short dated bond funds with a credit score of 1.25	AAA	T+1 to T+5	yes	100	1 Year
4. Ultra short dated bond funds with a credit score of 1.5	AAA	T+1 to T+5	yes	100	1 Year
5. Bond Funds	AAA	T+2 or longer	yes	100	1 Year
6. Gilt Funds	AAA	T+2 or longer	yes	100	1 Year

*Note 1. The objective of MMFs is 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	100	1 Year
UK Government Gilts	UK sovereign rating	Sale T+1	yes	100	1 Year
Bond issuance issued by a financial institution which is explicitly guaranteed by the UK Government e.g. National Rail	UK sovereign rating	Sale T+3	yes	100	1 Year
Sovereign bond issues (other than the UK govt)	AAA	Sale T+1	yes	80	1 Year
Bonds issued by multilateral development banks	AAA	Sale T+1	yes	80	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	Green	Sale T+0	yes	50	2 Years
Commercial paper other	Green	Sale T+0	yes	20	2 Years
Floating rate notes	Green	Sale T+0	yes	20	2 Years
Corporate Bonds other	Green	Sale T+3	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.

## 1.6 Other

	* Minimum Credit Criteria / fund rating	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Property funds	--	T+4	yes	100	5 Years

**Table 2: permitted investments for use by external 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	50	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**	UK sovereign rating	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 Fund Rating	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
1. Government Liquidity Funds	AAA	instant	No see note 1	100	1 Year
2a. Money Market Funds CNAV	AAA	instant	No see note 1	100	1 Year
2b. Money Market Funds LVNAV	AAA	instant to T+5	No see note 1	100	1 Year
2c. Money Market Funds VNAV	AAA	instant to T+5	No see note 1	100	1 Year
3. Ultra short dated bond funds with a credit score of 1.25	AAA	T+1 to T+5	yes	100	1 Year
4. Ultra short dated bond funds with a credit score of 1.5	AAA	T+1 to T+5	yes	100	1 Year
5. Bond Funds	AAA	T+1 to T+5	yes	100	1 Year
6. Gilt Funds	AAA	T+1 to T+5	yes	100	1 Year

*Note 1. The objective of these funds is 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	100	1 Year
UK Government Gilts	UK sovereign rating	Sale T+1	yes	100	1 Year
Bond issuance issued by a financial institution which is explicitly guaranteed by the UK Government e.g. National Rail	UK sovereign rating	Sale T+3	yes	100	1 Year
Sovereign bond issues (other than the UK govt)	AAA	Sale T+1	yes	80	1 Year
Bonds issued by multilateral development banks	AAA	Sale T+1	yes	80	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	Green	Sale T+1	yes	50	1 year
Commercial paper other	Green	Sale T+1	yes	50	1 year
Corporate Bonds other	Green	Sale T+3	yes	20	1 year
Floating Rate Notes	Green	Sale T+1	yes	20	1 year

**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.

## 2.6 Other

	* Minimum Credit Criteria / fund rating	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Property funds	--	T+4	yes	20	5 Years

## Appendix 6 – Treasury Management Practice (TMP2) Credit and Counterparty Risk Management

The following table is for use by the Treasury team and is a list of current counterparties. However, the use of counterparties depends on credit ratings and the Council may stop using certain counterparties and may stop using certain counterparties and/or decide to use alternative counterparties within its permitted investments. If for unavoidable short term operation reasons, limits are breached this will be communicated to management immediately.

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

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good Limits
<b>Cash type instruments</b>				
a. Deposits with the Debt Management Account Facility (UK Government) <b>(Very low risk)</b>	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 <b>(Very low risk)</b>	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	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 2 years.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good Limits
	<p>agreement of the counterparty, and penalties can apply.</p> <p>Deposits with other non-local authority bodies will be restricted to the overall credit rating criteria.</p>			
c. Money Market Funds (MMFs) – CNAV/LVNAV/VNAV ( <b>Low to very low risk</b> )	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.	£10m per fund	100%
d. Ultra short dated bond funds ( <b>low risk</b> )	Pooled cash investment vehicle which provides very low counterparty, liquidity and market risk. These will primarily be used as liquidity instruments.	Funds will only be used where they have a “AAA” rated status from either Fitch, Moody’s or Standard and Poor’s.	£10m	100%
e. Call account deposit accounts with financial institutions (banks and building societies) ( <b>Low risk depending on credit rating</b> )	These tend to be low risk investments, but will exhibit higher risks than categories (a), (b) and (c) above. Whilst there is no risk to value with these types of investments, liquidity is high and investments can be returned at short notice.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody’s and Standard and Poor’s. Day to day investment dealing with this criteria will be further strengthened by use of additional market intelligence.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.
f. Term deposits with financial institutions (banks and building	These tend to be low risk investments, but will exhibit higher risks than categories (a), (b) and (c)	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured	As shown in the counterparty	As shown in the counterparty

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good Limits
societies) ( <b>Low to medium risk depending on period &amp; credit rating</b> )	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.	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.	section criteria above.	section criteria above.
g. Government Gilts and Treasury Bills ( <b>Very low risk</b> )	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.	£10m maximum 1 year.	100% maximum 1 year.
h. Certificates of deposits with financial institutions ( <b>Low risk</b> )	These are short dated marketable securities issued by financial institutions and as such counterparty risk is low, but will exhibit higher risks than categories (a), (b) and (c) above. There is risk to value of capital loss arising from selling ahead of maturity if combined with an adverse movement in interest rates (no loss if these are held to maturity). Liquidity risk will normally be low.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's. Day to day investment dealing with this criteria will be further strengthened by the use of additional market intelligence.	£10m per counterparty maximum 1 year.	20% maximum 1 year.
i. Structured deposit facilities with banks and building societies	These tend to be medium to low risk investments, but will exhibit higher risks than categories (a), (b) and (c)	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured	As shown in the counterparty	As shown in the counterparty



Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good Limits
(escalating rates, de-escalating rates etc.) <b>(Low to medium risk depending on period &amp; credit rating)</b>	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).	primarily by credit ratings from Fitch, Moody's and Standard and Poor's. Day to day investment dealing with this criteria will be further strengthened by the use of additional market intelligence.	section criteria above.	section criteria above.
j. Corporate bonds <b>(Medium to high risk depending on period &amp; credit rating)</b>	These are marketable securities issued by financial and corporate institutions. Counterparty risk will vary and there is risk to value of capital loss arising from selling ahead of maturity if combined with an adverse movement in interest rates. Liquidity risk will be low.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's. Corporate bonds will be restricted to those meeting the base criteria.  Day to day investment dealing with this criteria will be further strengthened by the use of additional market intelligence.	£5m and maximum 1 year.	£20% and maximum 1 year.
Other types of investments				
a. Investment properties	These are non-service properties which are being held pending disposal or for a longer term rental income stream. These are highly illiquid assets with high risk to value (the potential for property prices to fall or for rental voids).	In larger investment portfolios some small allocation of property based investment may counterbalance/compliment the wider cash portfolio.  Property holding will be re-valued regularly and reported annually with gross and net rental streams.	£10m	20%.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good Limits
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.	£10m and maximum 5 years.	10% and maximum 5 years.
c. 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%
d. 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%
e. 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 Financial Services 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.	N/A

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good Limits
f. 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 Financial Services 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.	N/A
g. 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 Financial Services 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 30 years.	N/A
h. Hub Co sub debt	These are non-service investments which may exhibit market risk, be only considered for longer term investments and will be likely to be highly illiquid.	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.	£10m	N/A
i. Investment in a project run by a Local Authority or Local Authority Joint Committee	These are investments which may exhibit market risks and will only be considered for medium to longer term investments	Each investment requires approval by the Head of Financial Services up to £250,000, and, above this level, member approval. Each application will be supported by the service rationale behind the investment and the likelihood of loss.	£10m	N/A

## Appendix 7 – Creditworthiness policy

### Service and Information provided by Link Asset Services

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.

This modelling approach combines credit rates, 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 of investments.

All credit ratings are monitored from a weekly list which can be updated daily by Link Asset Services. The Council is alerted to the changes to ratings of all three agencies through the use of Link Asset Services credit worthiness service.

If a downgrade results in the counterparty/investment scheme no longer meeting the Council's minimum criteria, immediate consideration will be given to whether funds should be withdrawn from this counterparty and the timescale for doing this.

In addition to the use of the credit ratings the Council will be advised of information in movements in Credit Default Swap against the iTraxx benchmark and other market data on a daily basis via Link Asset Service's Passport website that the Council can access. Extreme market movements may result in a downgrade of an institution or removal from the Councils lending list.

Based on the Link Asset Services approach, the Council will therefore use counterparties within the following durational bands:

Yellow	5 years*
Dark pink	5 years for Ultra short dated bond funds with a credit score of 1.25
Light pink	5 years for Ultra short dated bond funds with a credit score of 1.5
Purple	2 years
Blue	1 year (only applies to nationalised or semi nationalised UK banks)
Orange	1 year
Red	6 months
Green	100 days
No colour	Not to be used

*\*The yellow colour category is for UK Government debt, or its equivalent, money market funds and collateralised deposits where the collateral is UK Government debt.*

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.

No more than £15m can be invested with each UK bank and £10m with any single other counterparty. The Council will place overnight and call deposits with the Council's bankers irrespective of credit rating. The limit on placing deposits with the Council's bankers is currently £5m.

Deposits can be placed with Local Authorities and other public sector bodies for a period up to 2 years.

The Council can invest an unlimited amount of money with the Debt Management Agency Deposit Facility (operated by the Debt Management Office which is part of HM Treasury). The longest period for a term deposit with the DMADF is 6 months.

## **Appendix 8 – Approved Countries for Investments (at 03.01.20)**

This list is based on those countries which have sovereign ratings of AA- or higher (we show the lowest rating from Fitch, Moody's and S&P) and also, (except - at the time of writing - for Hong Kong, Norway and Luxembourg), have banks operating in sterling markets which have credit ratings of green or above in the Link Asset Services credit worthiness service.

### AAA

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

### AA+

- Finland
- U.S.A.

### AA

- Abu Dhabi (UAE)
- Hong Kong
- France

### AA-

- Belgium
- Qatar

## **Appendix 9 – Treasury Management Scheme of Delegation**

### **The Council**

- Overall responsibility for Treasury Management Strategy.
- Adoption of Treasury Policy Statements.
- Receive an Annual Report and other reports on the Treasury Management Operation and on the exercise of delegated treasury management powers.

### **The Policy and Resources Committee**

- Responsibility for the overall investment of money under the control of the Council.
- Keeping under review the level of borrowing.
- Approval of Annual Strategy Statement.
- Receiving and reviewing reports on treasury management policies, practices and activities.
- Approval of Treasury Policy Statements.
- Implementation and monitoring of Treasury Management Policies and Practices.

### **The Audit and Scrutiny 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.
- Reviewing the treasury management policy and procedures and making recommendations to the responsible body.

## Appendix 10 – The Treasury Management Role of the Section 95 Officer

### Section 95 Officer:

- Recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance.
- Submitting regular treasury management policy reports.
- Submitting budgets and budget variations.
- Receiving and reviewing management information reports.
- Reviewing the performance of the treasury management function.
- Ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function.
- Ensuring the adequacy of internal audit, and liaising with external audit.
- Recommending the appointment of external service providers.
- Reviewing and considering risk management in terms of treasury activities.
- preparation of a capital strategy to include capital expenditure, capital financing, non-financial investments and treasury management, with a long term timeframe
- ensuring that the capital strategy is prudent, sustainable, affordable and prudent in the long term and provides value for money
- ensuring that due diligence has been carried out on all treasury and non-financial investments and is in accordance with the risk appetite of the authority
- ensure that the authority has appropriate legal powers to undertake expenditure on non-financial assets and their financing
- ensuring the proportionality of all investments so that the authority does not undertake a level of investing which exposes the authority to an excessive level of risk compared to its financial resources
- ensuring that an adequate governance process is in place for the approval, monitoring and ongoing risk management of all non-financial investments and long term liabilities
- provision to members of a schedule of all non-treasury investments including material investments in subsidiaries, joint ventures, loans and financial guarantees ensuring that members are adequately informed and understand the risk exposures taken on by an authority
- ensuring that the authority has adequate expertise, either in house or externally provided, to carry out the above
- creation of Treasury Management Practices which specifically deal with how non-treasury investments will be carried out and managed, to include the following: -
  - *Risk management (TMP1 and schedules), including investment and risk management criteria for any material non-treasury investment portfolios;*
  - *Performance measurement and management (TMP2 and schedules), including methodology and criteria for assessing the performance and success of non-treasury investments;*
  - *Decision making, governance and organisation (TMP5 and schedules), including a statement of the governance requirements for decision making in relation to non-treasury investments; and arrangements to ensure that*



*appropriate professional due diligence is carried out to support decision making;*

- *Reporting and management information (TMP6 and schedules), including where and how often monitoring reports are taken;*
- *Training and qualifications (TMP10 and schedules), including how the relevant knowledge and skills in relation to non-treasury investments will be arranged.*

**The nominated Elected Member (Policy Lead for Strategic Finance and Capital):**

- 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.

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**ARGYLL AND BUTE COUNCIL****COUNCIL****FINANCIAL SERVICES****27 FEBRUARY 2020**

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**LOANS FUND REVIEW**

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**1. INTRODUCTION**

- 1.1 This report introduces a revised policy on loans fund advance repayment profiling following a review of the current loans fund. A briefing containing much of the content of this report was issued to Members on 23 January 2020 and was presented at the Members Seminar on 27 January 2020.

**2. BACKGROUND**

- 2.1 The Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016 (the Regulations) came into force on 1 April 2016 replacing the statutory provisions for local authority borrowing, lending and loans fund as set out in Schedule 3 of the Local Authority (Scotland) Act 1975.
- 2.2 The Regulations stipulate that local authorities must operate a loans fund (which we currently do), which enables the council to recognise the amount of capital expenditure being financed by borrowing each year and the amount of this borrowing being repaid each year and charged to the revenue account. All borrowing undertaken to fund the capital programme must be repaid through the loans fund on a prudent basis.
- 2.3 The Regulations have changed the basis on which the loans fund is accounted for. The change moves from a prescriptive basis on how the repayment values are to be calculated (maximum periods permitted for each asset class), to a prudent one with each local authority allowed to determine what is prudent. These changes in Regulations have brought in more flexibility for local authorities to repay the outstanding loans fund advances over a different period, if it can be justified as prudent to do so.
- 2.4 The Regulations also stated that a local authority may subsequently vary the period or the amount of repayment (or both), if it considers it prudent.
- 2.5 A review of the Council's loans fund advance repayments has been undertaken with advice from our Treasury Advisors, Link Asset Services.
- 2.6 The review was undertaken to ensure the Council continues to make a prudent provision each year for the repayment of loans fund advances. It is up to each Council to manage appropriately and to determine prudent repayment based on its own individual circumstances.

### **3. REVIEW**

- 3.1 A loans fund advance relates to the capital investment that is being funded by borrowing.
- 3.2 The review considered new loans fund advances and historic loans fund advances to assess whether the repayment methodology was still the most prudent option. Data was available for loans fund advances from 2004-05 onwards.
- 3.3 The repayment of loans fund advances is based on two elements:
- The period set for which each advance is to be repaid to the loans fund.
  - The annuity interest rate (the method used which links the repayments of the borrowing to the flow of benefits from an asset where the benefits are expected to increase in later years).

### **4. LOAN FUND REPAYMENTS**

#### **4.1 Period of Repayment**

- 4.1.1 The statutory guidance identifies that the broad aim of a prudent repayment is to ensure that the debt is repaid over a period that is reasonably commensurate with that over which the capital expenditure provides benefits.
- 4.1.2 Some of the current loan repayment periods are a lot shorter than the life of the associated asset and some are longer. To profile over a shorter period is imprudent as it could be viewed as requiring the tax payer to repay capital investment before receiving the full benefit from the asset. Conversely, profiling over a longer period could mean that the tax payers are not repaying the full capital investment before the asset's life has ended.
- 4.1.3 The method considered most appropriate for the Council is asset life annuity method for all new advances (this includes new advances within financial year 2019-20). The flexibility of the Regulations allows Councils to re-profile loan fund repayments retrospectively and for the historic loans fund advances the method considered most appropriate is the simplified annuity method that uses an average repayment period.
- 4.1.4 Since the inception of Argyll and Bute Council in 1996, the policy on repayment periods has never been updated and is noted in the table below.

Asset Class (Current Policy)	Repayment Period (years)
Land	60
Schools	40
Bridges	30
Piers and Harbours	30
Buildings	20
Roads	20

Street Lighting	20
Repairs and Renewals	20
Plant	10
Vehicles	Up to 7
Office Equipment	Up to 5
IT Equipment	Up to 3

- 4.1.5 The current policy of using asset class to determine the period of repayment is a prudent option to continue with for all new loans fund advances. However, it is accepted that in recent years, increasing pressure on capital budgets and constraints on capital funding have meant greater emphasis on maintaining existing assets rather than creating new assets, and improvements to building design, technology and materials mean that buildings are lasting longer than previously expected. The proposed new list of asset classes/repayment periods are outlined within the table below.

Asset Class (Proposed Revised Policy)	Repayment Period (years)
Land (including Cemeteries)	100
Road Structures - Bridges, Retaining Walls, Sea Walls, Flood Defences	60
Piers and Harbours	60
Roads & Footways	20
Street Lighting	30
Vehicles & Plant	7
IT Equipment	5
Major Regeneration Works (Public Realm etc)	60
New Builds including Schools	60
Buildings - Electrical	40
Buildings - Plant	20
Buildings - Roofing	35
Buildings - Windows & External Doors	20
Buildings - Structural	25

- 4.1.6 The historic loans fund advances were also reviewed to assess whether the repayment methodology was still the most prudent option based on the information we had available. Data was available for loans fund advances from 2004-05 onwards.
- 4.1.7 A review of the asset lives used in the loans fund calculations since 2004-05 shows that various different repayment periods had been used when setting the period for advance repayments. Generally they range between 20 and 60 years, however, there are IT assets and vehicles that are repaid over a shorter period. The analysis of advances between 2004-05 and 2018-19 are noted in the table below.

Advance Period	New Advances £000	Advances %
1-19 years	1,556	1%
20-29 years	100,409	44%
30-39 years	31,686	14%
40+ years	91,883	41%
	<b>225,534</b>	<b>100%</b>

- 4.1.8 The Council's average loan repayment period on new borrowing taken between 2004-05 and 2018-19 was 26 years. During the current review, when considering the appropriate period to reasonably reflect the period over which communities receive the economic benefit of the assets a number of factors have been taken into account to determine what a prudent repayment period should be. Over a number of years the entering of the repayment periods within the loans fund has been inconsistent and there are a number of the repayment periods that should have been longer. In correcting this position the average loan repayment period increased to 30 years. As previously mentioned there is now increasing pressure on capital budgets with greater emphasis on maintaining existing assets and building design, technology and materials are seeing assets lasting longer than previously expected. It is therefore prudent to assume that the repayment period could be increased above the historic corrected average.
- 4.1.9 Taking this into account, it is considered prudent to revise the repayment period on historic debt between 2004-05 and 2018-19 using an average loan repayment period of 32 years. It should be noted that one of the reasons that the asset life method is not recommended for the historic repayments is due to the limited data and in some cases it was difficult to be fully sure what the capital advance was for. The average repayment period suggested is the most prudent option.
- 4.1.10 The majority of the loans outstanding at 1 April 2004 had a remaining life of between 1-19 years. Further analysis confirmed that the average remaining life for loans fund advances outstanding at 1 April 2004 was 14 years and it is suggested that a repayment period of 14 years is used for these loans fund advances.

## **4.2 Annuity Interest Rate**

- 4.2.1 The statutory duty to administer the loans fund in accordance with prudent financial management extends to the interest rate selected for the annuity calculation. The statutory guidance does not include guidance on what is an appropriate interest rate for the annuity but suggests that a Council should set out their policy on interest rate selection and apply that policy consistently.
- 4.2.2 The overall average loans fund borrowing rate over the period 2004-05 to 2018-19 taking into account the outstanding borrowing in each year was 5.1%. It is proposed that an annuity interest rate of 5.1% is used for new loans fund advances and retrospective advances.

- 4.2.3 Once calculated it is only the principal element of the calculation that represents the annual repayment of the loans fund advance as the Council pools its borrowing and interest is paid based on a fixed interest rate.
- 4.2.4 At the beginning of a loans fund advance the principal repayment is less and this situation reverses as you move into the later years of the borrowing. This means that over the time of the loan the principal repayments will increase. As all the outstanding loans are effectively being consolidated with a 32 years average pay back, the principal repayments will continue to increase until 2036-37 (the end of the repayment period for loans fund advances taken in 2004-05) and it would be prudent for the Council to make an allowance for this increase.

## **5. RESULTS OF REVISED METHODOLOGY**

- 5.1 To summarise, the revised repayment methods considered appropriate are as follows:
- Using a repayment period of 14 years for loans fund balances outstanding as at 1 April 2004.
  - Using a repayment period of 32 years for advances between 2004-05 and 2018-19.
  - Using a repayment period linked to an updated list of asset lives for new loans fund advances from 1 April 2019.
  - Using a 5.1% annuity interest rate.
  - All previous prudential borrowing arrangements will be included within the re-calculation and the revenue budget added into the loans fund budget on a permanent basis, with the exception of vehicle purchases from 2017-18 onwards as these are borrowed on a prudential borrowing basis with a 7 year pay-back arrangement and piers and harbours infrastructure as there is already a model for this which is funded via increased fees and charges.
- 5.2 The results of applying the revised methodology to the current outstanding loans fund advances and assumed future advances (based on the current three year capital plan) will give rise to a medium term (5 year) revenue saving in addition to a one-off re-profiling gain in relation to prior year repayments. The one-off re-profiling gain can be taken in future years in any way the authority wishes, as long as it deems it to be prudent and does not result in a negative charge. This means that the gain released each year is limited to the principal repayments in year (currently circa £5m per annum).
- 5.3 The saving on the loans fund repayments over the next 5 years (excluding prudential borrowing vehicles and piers and harbours) is summarised within the table below. It also takes into consideration the current surplus/deficit in the loans fund model over the current year and next five years.

Column A	Column B	Column C	Column D	Column E
Year	Current Estimate Loans Funds Advance Repayments	Revised Estimate Loans Fund Advance Repayments	Loans Fund Model Estimated Outturn (overspend) / underspend	Reduction in Loans Fund Advance Repayments
	£000	£000	£000	£000
2019-20	7,304	4,841	(96)	2,367
2020-21	7,710	5,117	(248)	2,345
2021-22	8,269	5,469	(320)	2,480
2022-23	8,645	5,702	(604)	2,339
2023-24	9,013	5,992	(739)	2,282
2024-25	8,938	6,299	(666)	1,973
	<b>49,879</b>	<b>33,420</b>	<b>(2,673)</b>	<b>13,786</b>

- 5.4 Column E in the Table above shows a saving of £2.367m within 2019-20. The current forecast outturn within 2019-20 as at the end of December 2019, not including this saving, amounts to £2.490m. Realising this saving would mean that the overall estimated outturn position as at the end of 2019-20 would be circa 100k overspent, subject to any additional over/underspends identified before the year end.
- 5.5 Column E in the table above shows a saving of £2.345m for financial year 2020-21. Column C demonstrates the point made in paragraph 4.2.4 that the principal repayments will increase year on year, currently increasing by circa £300k. Taking a longer term view, it would be prudent to make a provision for the increasing principal repayments over the next 10 years and based on a recurring revenue saving of £2.5m, a provision of £7.649m would be required. It should be noted that this provision will not cover the increasing principal repayments through to 2036-37, however it does provide the budget required over the next 10 years, giving the Council time to plan for the period beyond that and also allows the Council to address the short-term liabilities/cost pressures as noted within the Revenue Budget Overview report in the Budget Pack. One of the short-term cost pressures noted relates to a provision to support organisational change with a view to increasing the amount of revenue savings in the future. This cost pressures would support setting aside a provision to cover the next 10 years increase in principal repayments on the basis that we should be able to increase revenue savings to fund further increases beyond the 10 years.
- 5.6 The one-off re-profiling gain is summarised in the table below and it has been reduced by the provision for increased principal repayments over the next 10 years.

Loans Fund Repayments	£000
Actual charge to 31/03/2019	237,091

Revised charge to 31/03/2019	216,530
<b>Excess to be adjusted for in future years</b>	<b>20,561</b>
Provision for increased repayments over 10 years	(7,649)
<b>One-off re-profiling gain</b>	<b>12,912</b>

- 5.7 There are a number of known liabilities/cost pressures that Council need to give consideration to and it would be prudent to fund these from the one-off re-profiling gain. Further information is contained within the Revenue Budget Overview Report in the Budget Pack 2020-21.

## 6. CONCLUSION

- 6.1 This report introduces a revised policy on loans fund advance repayment profiling following a review of the current loans fund. It is up to each Council to manage appropriately and to determine prudent repayment based on its own individual circumstances.
- 6.2 The results of applying the recommended revised methodology give rise to a revenue saving in addition to a one-off re-profiling gain in relation to prior year repayments.
- 6.3 It would be prudent to use the one-off re-profiling gain to make a provision for the estimated rise in principal repayments over the next 10 years and to fund the current known and emerging liabilities/cost pressures as outlined within the Revenue Budget Overview Report.

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13 January 2020