East Lothian Council

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REPORT TO: Election Recess Arrangements – s43 Standing Orders

MEETING DATE:

BY: Chief Finance Officer

SUBJECT: Capital Investment & Treasury Management Strategy 2012/13 to 2014/15

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1 PURPOSE

1.1 To outline the Council's approach to managing capital investment and treasury management in 2012/13 to 2014/15.

2 RECOMMENDATIONS

2.1 The Council is recommended to :

i. Note the Capital Investment Strategy detailed in section 3.4.

ii. Approve Authorised limits for external debt as detailed in section 3.4.5.

iii. Approve Operational boundaries for external debt as detailed in section 3.4.6.

iv. Approve the delegation of authority to the Head of Council Resources to effect movement between external borrowing and other long-term liabilities as detailed in section 3.4.7.

v. Approve the Treasury Management Strategy appended.

3 BACKGROUND

3.1 It is a statutory requirement under Section 93 of the Local Government Finance Act 1992, that the Council produces a balanced budget. In particular, a local authority must calculate its budget for each financial year to include the revenue costs that flow from capital financing decisions. This, therefore, means that increases in capital expenditure must be limited to a level whereby increases in charges to revenue from:

- Increases in interest charges caused by increased borrowing to finance additional capital expenditure, and
- Any increases in running costs from new capital projects

are limited to a level that is affordable within the projected income of the Council for the foreseeable future.

3.2 On 8 February 2011, the Council approved a Capital Investment and Treasury Management Strategy for 2011/12 to 2013/14. This ensured compliance with regulatory requirements to have in place both a Treasury Management Strategy and Prudential Indicators for the management of capital investment.

3.3 This report updates that Strategy, moving indicators forward by 1 year to include 2014/15 and making amendments to the Strategy to take into account activity over the last year. The figures used are based on those utilised in setting the Council Tax and HRA rents on 14 February 2012.

3.4 **CAPITAL INVESTMENT STRATEGY**

3.4.1 Actual capital expenditure incurred in 2010/11 and the estimates of total gross capital expenditure to be incurred for 2011/12 and future years are:

Capital	2010/11	2011/12	2012/13	2013/14	2014/15
	£'000	£'000	£'000	£'000	£'000
	actual	estimate	estimate	estimate	estimate
General Services	45,073	39,935	37,283	36,426	31,994
HRA	11,740	37,405	32,111	22,328	32,743
TOTAL	**56,813**	**77,340**	**69,394**	**58,754**	**64,737**

3.4.2 Estimates of the ratio of financing costs to net revenue stream for the current and future years, and the actual figures for 2010/11 are:

Ratio of financing costs to revenue stream	2010/11	2011/12	2012/13	2013/14	2014/15
	%	%	%	%	%
	actual	estimate	estimate	estimate	estimate
General Services	6.57%	7.12%	7.79%	8.46%	9.16%
HRA	20.24%	26.48%	32.41%	36.22%	38.24%

The gradual increase in the General Services ratio mainly reflects the anticipated standstill in corporate income. The rapid increase in the HRA ratio reflects the large planned investment in new affordable housing, which is mainly financed through borrowing. This borrowing has to be repaid with interest and this leads to increased financing costs.

3.4.3 The Capital Financing Requirement (CFR) measures the Council's underlying need to borrow for a capital purpose. In accordance with best professional practice, the Council does not associate borrowing with particular items or types of expenditure. The authority has an integrated treasury management strategy and has adopted the CIPFA Code of Treasury Management in the Public Services. The Council has at any point in time a number of cash flows both positive and negative. In day-to-day cash management, no distinction is made between revenue cash and capital cash. External borrowing arises as a consequence of all the financial transactions of the Council and not simply those arising from capital spending. However, other than to manage short-term cash flows, the Council is not allowed to borrow for revenue purposes.

3.4.4 Estimates of the end of year capital financing requirement (CFR) for the Council for the current and future years, and the actual CFR at 31 March 2011 are:

Capital Financing Requirement as at 31 March	2010/11	2011/12	2012/13	2013/14	2014/15
	£'000	£'000	£'000	£'000	£'000
	actual	estimate	estimate	estimate	estimate
General Services	240,473	257,857	273,752	290,053	287,003
HRA	81,385	112,785	139,159	150,429	177,889
TOTAL	**321,858**	**370,642**	**412,911**	**440,482**	**464,892**

The importance of the CFR lies in the way it measures the need to borrow for a capital purpose excluding the effect of revenue cash flows.

The key indicator of prudence is that net external borrowing should not exceed the CFR for the preceding year plus additional CFR in the current and two following years. At the close of the 2010/11 financial year, the Council was well within this indicator, as the relevant CFR was £282,483,000 and external borrowing was £255,138,000.

3.4.5 The Council is recommended to approve the following authorised limits for its gross external debt for the next three years. These limits separately identify borrowing from other long-term liabilities such as finance leases.

Authorised Limit	2010/11 £'000 estimate	2011/12 £'000 estimate	2012/13 £'000 estimate	2013/14 £'000 estimate	2014/15 £'000 estimate
Borrowing	424,000	449,000	450,000	451,000	451,000
Other long term liabilities	57,000	56,000	55,000	54,000	54,000
TOTAL	**481,000**	**505,000**	**505,000**	**505,000**	**505,000**

These authorised limits are consistent with the Council's current commitments, existing plans and the budget proposals for capital expenditure and financing, and with the approved treasury management policy. The limits are based on the estimate of the most likely, prudent but not worst-case scenario with, in addition, sufficient headroom over and above this to allow for the operational management of unusual cash flows, such as debt restructuring.

3.4.6 The Council is also asked to approve the following operational boundaries for gross external debt. These are based on the authorised limits but excluding headroom.

Operational Boundary for external debt	2010/11 £'000 actual	2011/12 £'000 estimate	2012/13 £'000 estimate	2013/14 £'000 estimate	2014/15 £'000 estimate
Borrowing	393,515	419,041	420,195	421,357	421,357
Other long term	46,967	45,851	44,697	43,535	43,535
TOTAL	**440,482**	**464,892**	**464,892**	**464,892**	**464,892**

3.4.7 The Council has delegated authority to the Head of Council Resources to effect movement between borrowing and long-term liabilities within the total authorised limits and operational boundaries approved. Any such movement would be reported to Cabinet via the Members Library as part of Treasury Management update reports.

3.4.8 Within the limits set by the indicators above, the Council will make capital investment decisions in accordance with the following fundamental principles of the Prudential Code:

- Service objectives e.g. achieving the Corporate Plan objectives
- Stewardship of assets e.g. asset management planning
- Affordability e.g. implications for Council Tax

- Value for money e.g. option appraisal
- Prudence and sustainability e.g. implications for external borrowing
- Practicality e.g. is the investment proposal practical given other competing pressures on the service involved

3.4.9 A key measure of affordability is the incremental impact of capital investment decisions on the Council Tax and Council House rents. The impacts of the expenditure plans are:

Incremental impact of capital investment decisions	2012/13 £ p estimate	2013/14 £ p estimate	2014/15 £ p estimate
Increase in council tax (band D) per annum	35.21	36.77	38.39
Increase in average housing rent per week	3.76	2.95	2.44

3.5 TREASURY MANAGEMENT STRATEGY

3.5.1 Treasury Management deals with the management of the Council's money. This is closely tied into significant flows of money involved in implementing the capital investment plans.

3.5.2 Managing money has become significantly more difficult since 2008 as the credit crunch and recession impacted upon the UK economy, which is the context for the Councils treasury management activity. The Treasury Management Strategy for 2012/13 is a complex document covering a range of risks and regulatory requirements, and is appended.

4 POLICY IMPLICATIONS

4.1 Implementation of Council policy will require capital expenditure. The policy effect of a proposed capital expenditure will be assessed as part of the project appraisal.

4.2 The limited resources available form an important constraint on the development of policy, which requires to be managed through the development of a sustainable corporate plan associated with a corporate asset management plan.

5 EQUALITIES IMPACT ASSESSMENT

5.1 This report is not applicable to the wellbeing of equalities groups and an Equalities Impact Assessment is not required.

6 RESOURCE IMPLICATIONS

6.1 Financial – these strategies are interwoven with the revenue and capital budgets. The expenditure and debt limits are implicit within the revenue budgets approved by the Council on 14 February 2012.

6.2 Personnel - none directly from this report although there may be implications arising from capital investment decisions.

6.3 Other – capital investment choices made have a major impact on the property, equipment and IT resources available for the delivery of services.

7 BACKGROUND PAPERS

7.1 CIPFA (2009) – "Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes"

7.2 CIPFA (2009) – "The Prudential Code for Capital Finance in Local Authorities"

7.3 Council 8 February 2011 – "Capital Investment & Treasury Management Strategy 2011/12 to 2013/14"

7.4 Council 14 February 2012 – all papers

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DATE	02/05/2012

Treasury Management Strategy Statement

2012/13

1. Introduction

1.1 Background

Treasury management is defined as:

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

1.2 Statutory requirements

The Local Government in Scotland Act 2003 (the Act) and supporting regulations requires the Council to **‘have regard to’** the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice to set Prudential and Treasury Indicators for the next three years to ensure that the Council’s capital investment plans are affordable, prudent and sustainable.

The Act therefore requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy (as required by Investment Guidance subsequent to the Act and included as paragraph 9 of this report), which sets out the Council’s policies for managing its investments and for giving priority to the security and liquidity of those investments.

1.3 CIPFA requirements

The Chartered Institute of Public Finance and Accountancy’s (CIPFA) Code of Practice on Treasury Management (revised November 2009) was adopted by this Council on 23 February 2010.

The primary requirements of the Code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council’s treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy - for the year ahead, a Mid-year Review Report and an Annual Report (stewardship report) covering activities during the previous year.

- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Audit & Governance Committee.

1.4 Treasury Management Strategy for 2012/13

The suggested strategy for 2012/13 in respect of the following aspects of the treasury management function is based upon the treasury officers' views on interest rates, supplemented with leading market forecasts provided by the Council's treasury adviser, Sector.

The strategy covers:

- Treasury limits in force which will limit the treasury risk and activities of the Council
- Prudential and Treasury Indicators
- The current treasury position
- The borrowing requirement
- Prospects for interest rates
- The borrowing strategy
- Policy on borrowing in advance of need
- Debt rescheduling
- The investment strategy
- Creditworthiness policy
- Policy on use of external service providers
- Scheme of delegation
- Role of the Section 95 officer

1.5 Balanced Budget Requirement

It is a statutory requirement under Section 93 of the Local Government Finance Act 1992, for the Council to produce a balanced budget. In particular, a local authority must calculate its budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. This, therefore, means that increases in capital expenditure must be limited to a level whereby increases in charges to revenue from: -

- Increases in interest charges caused by increased borrowing to finance additional capital expenditure, and;
- Any increases in running costs from new capital projects are limited to a level which is affordable within the projected income of the Council for the foreseeable future.

2. Treasury Limits for 2012/13 to 2014/15

It is a statutory duty under part 7 of the Local Government in Scotland Act 2003 and supporting regulations, for the Council to determine and keep under review how much it can afford to allocate to capital expenditure. The amount so determined is termed the "Affordable Capital Expenditure Limit". In Scotland the estimate of capital expenditure represents the legislative limit specified in section 35(1) of the Local Government in Scotland Act 2003.

The Council must have regard to the Prudential Code when setting the Affordable Capital Expenditure Limit, which essentially requires it to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax and council rent levels is 'acceptable'.

Whilst termed an "Affordable Capital Expenditure Limit", the capital plans to be considered for inclusion incorporate financing by both external borrowing and other forms of liability, such as credit arrangements. The affordable capital expenditure limit is to be set, on a rolling basis, for the forthcoming financial year and two successive financial years.

3. Prudential & Treasury Indicators

These indicators for the period 2012/13 to 2014/15 are included within the Treasury Management report.

4. Current Portfolio Position

The Council's treasury portfolio position at 31st March 2012 comprised

		Principal		Ave. rate
		£m	£m	%
Fixed rate funding	PWLB	239.1		
	Market	40.2	279.3	4.23
Variable rate funding	PWLB	0.0		
	Market	5.0	5.0	0.45
Estimated Other long term liabilities			47.4	
Gross debt			**331.7**	**4.17**
Total investments			**0.0**	**0.00**
Net debt			**331.7**	

5. Borrowing Requirement

The Council's borrowing requirement is as follows:

	2012/13 £'000 estimate	2013/14 £'000 estimate	2014/15 £'000 estimate
New borrowing	42,269	27,571	24,410
Alternative financing arrangements	0	0	0
Replacement borrowing	9,660	14,476	8,356
Total Borrowing requirement	51,929	42,047	32,766

6. Prospects for Interest Rates

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

Sector Bank Rate forecast for financial year ends (March)

- 2011/12 0.50%
- 2012/13 0.55%
- 2013/14 1.25%
- 2014/15 2.50%

There is downside risk to these forecasts if recovery from the recession proves to be weaker and slower than currently expected. A detailed view of the current economic background is contained within appendix 3 to this report.

7. Borrowing Strategy

7.1 Borrowing rates

The Sector forecast for the new borrowing rate over the next two year is as follows: -

	Bank Rate	Money Rates		PWLB Borrowing Rates		
		3 month	1 year	5 year	25 year	50 year
March 2012	0.50	0.70	1.50	2.30	4.20	4.30
June 2012	0.50	0.70	1.50	2.30	4.20	4.30
Sept 2012	0.50	0.70	1.50	2.30	4.30	4.40
Dec2012	0.50	0.70	1.60	2.40	4.30	4.40
March 2013	0.50	0.75	1.70	2.50	4.40	4.50
June 2013	0.50	0.80	1.80	2.60	4.50	4.60

Sept 2013	0.75	0.90	1.90	2.70	4.60	4.70
Dec 2013	1.00	1.20	2.20	2.80	4.70	4.80
March 2014	1.25	1.40	2.40	2.90	4.80	4.90
June 2014	1.50	1.60	2.60	3.10	4.90	5.00

A more detailed Sector forecast is included in Appendix 1.

The Council's borrowing strategy will give consideration to all types of borrowing including temporary borrowing from the money markets, long term borrowing from the money markets, PWLB and East Lothian Bonds(1)

1. East Lothian Bonds – the Council has agreed in principle to explore the local issuance of bonds and once development is completed these may be an attractive source of borrowing

Sensitivity of the forecast – In normal circumstances the main sensitivities of the forecast are likely to be the two scenarios noted below. The Council officers, in conjunction with the treasury advisers, will continually monitor both the prevailing interest rates and the market forecasts, adopting the following responses to a change of sentiment:

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

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

8 Policy on borrowing in advance of need

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

In determining whether borrowing will be undertaken in advance of need the Council will:

- Ensure that there is a clear link between the capital programme and maturity profile of the existing debt portfolio which supports the need to take funding in advance of need
- Ensure the ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered
- Evaluate the economic and market factors that might influence the manner and timing of any decision to borrow
- Consider the merits and demerits of alternative forms of funding
- Consider the alternative interest rate bases available, the most appropriate periods to fund and repayment profiles to use
- Consider the impact of borrowing in advance on temporarily (until required to finance capital expenditure) increasing investment cash balances and the consequent increase in exposure to counterparty risk, and other risks, and the level of such risks given the controls in place to minimise them

9. Debt Rescheduling

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

The reasons for any rescheduling to take place will include:

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

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

All rescheduling will be reported to the Cabinet via Members Library.

10. Annual Investment Strategy

10.1 Investment Policy

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

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

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

Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

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

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

Investment instruments identified for use in the financial year are listed in appendices 3 and 4. Counterparty limits will be as set through the Council's Treasury Management Practices – Schedules.

11. Creditworthiness policy

11.1 Approach

This Council will apply the creditworthiness service provided by Sector. This service employs utilises credit ratings from the three main credit rating agencies - Fitch, Moodys and Standard and Poors. The credit ratings of counterparties are supplemented with the following overlays:

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

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

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

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

Typically the minimum credit ratings criteria the Council use will be a short term rating (Fitch or equivalents) of Short Term rating F1, Long Term rating A-, Viability ratings of BB+, and a Support rating of 3. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

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

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

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

11.2 Country limits

The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA+ from Fitch Ratings (or equivalent from other agencies if Fitch does not provide). The list of countries that qualify using this credit criteria as at the date of this report are shown in Appendix 5. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

11.3 Council Permitted Investments

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

The permitted investments which may be used in the forthcoming year are

Cash type instruments

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

- Supranational Bonds (e.g. World Bank)
- Certificates of deposits with financial institutions (banks and building societies)
- Structured deposit facilities with banks and building societies (escalating rates, de-escalating rates etc.);
- Corporate bonds;
- Bond funds;
- Property funds;

Other investments

- Investment properties;
- Loans to third parties, including soft loans;
- Loans to a local authority company;
- Shareholdings in a local authority company;
- Non-local authority shareholdings.

Details of the risks, mitigating controls and limits associated with each of these permitted categories are shown in Appendix 4.

For those permitted cash type investments the Chief Finance Officer will maintain a counterparty list in compliance with the counterparty selection criteria as stated above. These criteria will be reviewed and revised as considered necessary and submitted to Council for approval as necessary. These criteria select which counterparties the Council will choose from, rather than defining what its investments are.

Common Good

On 27 October 2009, the Council took the decision to invest the surplus funds on each of the Common Goods on a longer term basis in an investment portfolio. Prior to this the Funds were invested through the Council Loans Fund.

The Funds are currently managed by Investec who also manage investments on behalf of East Lothian Council's charitable trusts. The Council has set the objective to balance growth in income and capital over the long term**. This is based on a medium risk strategy which is outlined below:-**

- **Medium** – "A significant proportion of the portfolio may be invested in individual equities, investment trusts and packaged products. In some market conditions, performance may be more variable in view of this higher equity content. However, portfolios will be well diversified as to sector coverage and the number of companies selected. They may also contain a proportion of smaller companies and less liquid investments. Direct overseas investments will normally be in the minority and there may be modest fixed-interest and/or cash content".

Reporting

- Investec produce performance reports on a quarterly basis comparing performance to set investment benchmarks. These reports are reviewed by the Head of Council Resources.

- A summary report will be submitted to the full Council at least once a year on the performance of the portfolio.

- Ad hoc reports will be submitted to the Council should any significant events occur which in the opinion of the Head of Council Resources might affect the performance of the portfolio or the security of the investments.

- Reports will be submitted to individual Common Good committees as requested.

11.4 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).

Investment returns expectations. Bank Rate is foreccast to remain unchanged at 0.5% before strating to rise from quarter 3 of 2013. Bank Rate forecasts for financial year ends (March) are:

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

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

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

2012/13	0.70%
2013/14	1.00%
2014/15	1.60%
2015/16	3.30%
2016/17	4.10%

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

11.5 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.

11.6. External fund managers

The Council does not currently use an external fund manager to manage Council cash. .

12. Policy on the use of external service providers

The Council uses Sector as its external treasury management advisors.

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

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

13. Scheme of delegation

Please see Appendix 6.

14 Role of the Section 95 officer

Please see Appendix 7.

Appendices

1. Interest rate forecasts
2. Economic background
3. Treasury Management Practice 1 – permitted investments
4. Treasury Management Practice 1 – treasury risk management
5. Approved countries for investments
6. Treasury Management scheme of delegation
7. The Treasury Management role of the Section 95 officer

Sector's Interest Rate View														
	Now	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Sector's Bank Rate View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.25%	2.50%
3 Month LIBID	0.94%	0.70%	0.70%	0.70%	0.70%	0.75%	0.80%	0.90%	1.20%	1.40%	1.60%	2.10%	2.40%	2.60%
6 Month LIBID	1.26%	1.00%	1.00%	1.00%	1.00%	1.10%	1.20%	1.40%	1.60%	1.80%	2.00%	2.50%	2.70%	2.90%
12 Month LIBID	1.76%	1.50%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.20%	2.40%	2.60%	3.10%	3.20%	3.30%
5yr PWLB Rate	1.93%	2.30%	2.30%	2.30%	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	3.10%	3.30%	3.50%	3.70%
10yr PWLB Rate	3.10%	3.30%	3.30%	3.40%	3.40%	3.50%	3.60%	3.70%	3.80%	4.00%	4.20%	4.40%	4.60%	4.80%
25yr PWLB Rate	4.18%	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%
50yr PWLB Rate	4.20%	4.30%	4.30%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%
Bank Rate														
Sector's View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.25%	2.50%
UBS	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-
Capital Economics	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-
5yr PWLB Rate														
Sector's View	1.93%	2.30%	2.30%	2.30%	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	3.10%	3.30%	3.50%	3.70%
UBS	1.93%	-	-	-	-	-	-	-	-	-	-	-	-	-

Capital Economics	1.93%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	-	-	-	-	-
10yr PWLB Rate														
Sector's View	3.10%	3.30%	3.30%	3.40%	3.40%	3.50%	3.60%	3.70%	3.80%	4.00%	4.20%	4.40%	4.60%	4.80%
UBS	3.10%	3.50%	3.50%	3.60%	3.70%	3.70%	3.70%	3.70%	3.70%	-	-	-	-	-
Capital Economics	3.10%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	-	-	-	-	-
25yr PWLB Rate														
Sector's View	4.18%	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%
UBS	4.18%	4.90%	4.90%	4.90%	4.90%	4.90%	4.90%	4.90%	4.90%	-	-	-	-	-
Capital Economics	4.18%	3.90%	3.90%	3.90%	3.90%	3.90%	3.90%	3.90%	3.90%	-	-	-	-	-
50yr PWLB Rate														
Sector's View	4.20%	4.30%	4.30%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%
UBS	4.20%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	-	-	-	-	-
Capital Economics	4.20%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	-	-	-	-	-

APPENDIX 2 Economic Background

4.1. Global economy

The outlook for the global economy remains clouded with uncertainty. The UK economy is struggling to generate a sustained recovery that offers solid optimism for the outlook for 2012, or possibly even into 2013. Consumer and business confidence levels are generally low – although the most recent Purchasing Managers Index survey provides some hope. It is, however, not easy to see potential for a significant increase in the growth rate in the short term.

The **Eurozone sovereign debt crisis** has abated somewhat following the agreement among Eurozone finance ministers to a second bailout package of €230bn for Greece in mid February. This is supposed to reduce the overall level of debt from 160% to 120% by 2020, provided the Greeks fully implement all the austerity measures, including the ones they did not implement from 2010. These are very optimistic expectations given that the Greek economy is still in recession and there appears to be little hope for a significant improvement in the competitiveness of the economy to reverse this trend in the near future. Many commentators, therefore, view this package as only buying time until the next crisis which could well result in a default - either “orderly” or “disorderly”.

The ECB took major action to alleviate the credit crunch in the Eurozone in December by providing long term funding to banks for three years at 1%. €500bn was taken by credit hungry banks in that first issue and a second issue at the end of February is likely to be equally enthusiastically taken up again. The other effect of this operation has been to make it highly attractive for Eurozone banks to use this new financing at 1% to buy new sovereign debt issues yielding significantly higher rates, pocketing a tidy profit. Predictably, this has led to a substantial drop in yields being demanded by the market on new issues by Eurozone governments and has considerably alleviated concerns for the viability of issues by southern Med countries.

One problem, nevertheless, that is increasing in the Eurozone is how to keep electorates on board with the prospect of continuing bailouts and painful austerity measures when the politicians agreeing these bailouts (on both sides) are subject to the disciplines of operating in democracies. Greece is due to go to the polls in April and, potentially, it is likely to be the anti austerity political parties which will gain substantial electoral support. Any ensuing coalition government is likely to apply pressure in respect of renegotiating the recently agreed bailout package. In addition, bailouts for Greece do not currently have majority electoral support in Germany where a general election is looming up in 2013. Nearer at hand though, is the French presidential election in May 2012 where Sarkozy is well behind the Socialist front runner who is campaigning on a platform of demanding the issuance of EU bonds to replace sovereign bonds; this is a policy which Germany regards as anathema.

However, there is reasonable hope that any potential default by Greece, and exit from the Eurozone, could be contained as Portugal and Ireland are seen by Germany as making major progress in implementing austerity measures in conjunction with receiving support from the electorates and unions in each country, unlike in Greece. However, long term progress also requires economic growth to enable these countries to escape from the stranglehold of their mountains of debt.

On the back of this “solution” to the Eurozone debt crisis there has been a major rally in equity markets. However, this rally has shallow foundations and is probably mainly a relief rally. Trading volumes so far in 2012 have been markedly thin with a particularly notable lack of conviction among pension funds to move back from the safety of cash into equities.

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

Hopes for broad based recovery have, therefore, focused on the **emerging markets**. China is now on a trend of relaxing credit restrictions to boost growth which has been flagging. However, current expectations are that it will maintain a reasonable rate of growth, though less than in previous years.

4.2 UK economy

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

Economic Growth. GDP growth has, basically, flat lined since the election of 2010 and, worryingly, the economic forecasts for 2012 and beyond have been revised lower on a near quarterly basis. With concerns of a potential return to recession, the Bank of England embarked on a £75bn second round of Quantitative Easing (QE) to stimulate economic activity in October 2011. After a disappointing -0.2% growth in Q4 2011, the MPC decided in February to take further action to start a third round of QE with another £50bn of gilt purchases. The MPC is currently split on whether there needs to be another increase in QE in 2012 after some reasonably encouraging economic statistics indicating that the fall in GDP in quarter 4 2011 looks like being a one off rather than the start of a new trend towards recession.

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

Inflation and Bank Rate. For the last two years, the MPC's contention has been that high inflation was the outcome of temporary external factors and other one offs (e.g. changes in VAT); that view remains in place with CPI inflation having fallen from the peak of 5.2% in September 2011 to 3.6% in January. They remain of the view that the rate will fall back to, or below, the 2% target level within the two year horizon.

AAA rating. The ratings agencies reaffirmed the UK's AAA sovereign rating in 2011 and expressed satisfaction with Government policy for deficit reduction. They have, though, warned that this could be reviewed if the policy were to change, or was seen to be failing to achieve its desired outcome. In line with that proviso, in February Moodys put the rating on review for possible downgrade due to concerns over the outlook for GDP growth and the potential for shocks from the Eurozone to also depress growth. However, the monthly Government deficit figures for January then came out a few days later and gave hope that the overall deficit for 2011/12 could come in £10bn under target! The high creditworthiness of the UK has ensured that the UK government is able to fund itself at historically low levels and, with the safe haven status from Eurozone debt also drawing in external investment, rates are likely to remain depressed for some time.

4.3 Sector's forward view

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

- the potential for the unravelling of the second Greek bailout package causing a worsening of the Eurozone debt crisis and heightened risk of the breakdown of the bloc or even of the currency itself;
- inter government agreement on how to deal with the Eurozone debt crisis could fragment, particularly as a result of upcoming election results;
- the impact of the Eurozone crisis on financial markets and the banking sector;
- the impact of the Government's austerity plan on confidence and growth and the need to rebalance the economy from services to exporting manufactured goods;
- the under-performance of the UK economy which could undermine the Government's policies that have been based upon levels of growth that increasingly seem likely to be undershot;
- a continuation of high levels of inflation;
- the economic performance of the UK's trading partners, in particular the EU and US, with some analysts suggesting that recession could return to both;

- stimulus packages failing to stimulate growth;
- elections due in the US, Germany and France in 2012 or 2013;
- potential for protectionism i.e. an escalation of the currency war / trade dispute between the US and China.

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

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

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

APPENDIX 3 - 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 are subject to the following risks: -

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

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

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

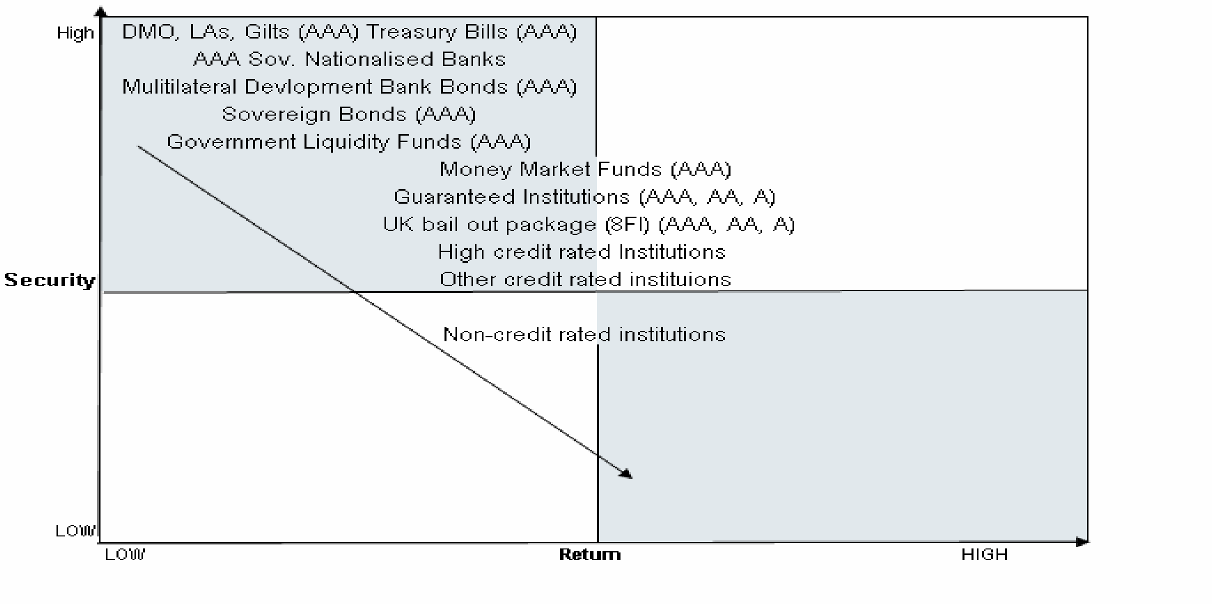
4. **Interest rate risk**: this is the risk that fluctuations in the levels of interest rates create an unexpected or unbudgeted burden on the organisation's finances, against which the organisation has failed to protect itself adequately. This authority has set limits for its fixed and variable rate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

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

in accordance with its legal powers or regulatory requirements, and that the organisation suffers losses accordingly.

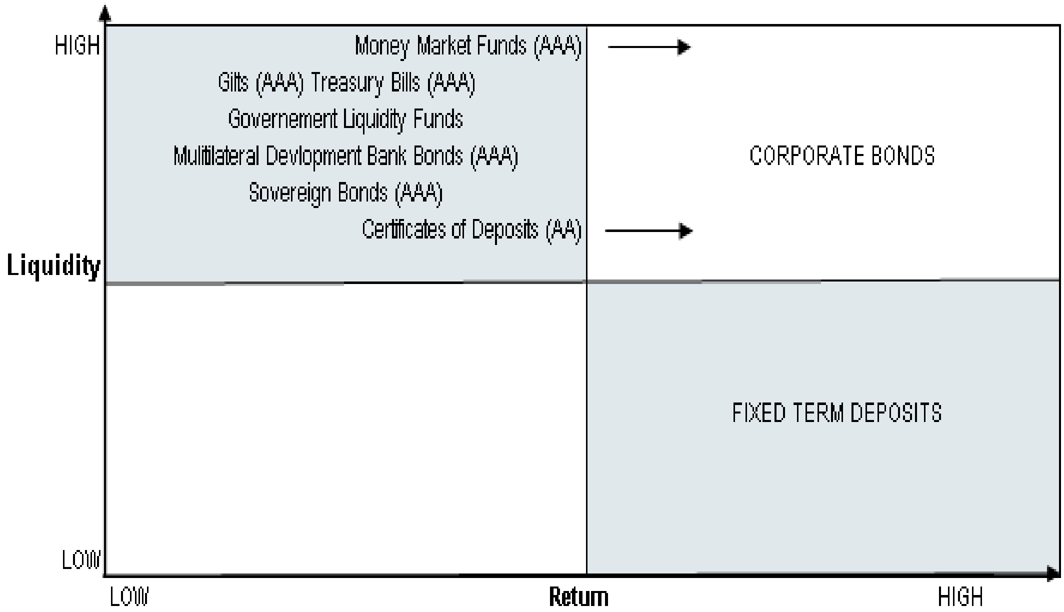
The graph below summarises the risk exposure of various types of investment instrument. It shows that as you move from top to bottom, so the level of credit risk increases. However, moving from top to bottom also results in moving towards the right i.e. returns increase. The overall message is: -

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



The next graph shows the other message: -

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



Controls on treasury risks

1. **Credit and counter-party risk:** this authority has set minimum credit criteria to determine which counterparties and countries are of high creditworthiness to enable investments to be made safely. See paragraph 7 below

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

3. **Market risk:** this authority does not purchase investment instruments which are subject to market risk in terms of fluctuation in their value OR (example) this authority purchases treasury bills as they offer a higher rate of return than depositing in the DMADF, the security is just as good, but they offer the benefit of being quickly saleable if the need arises for extra cash at short notice and their value does not vary much during their short life.

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

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

Unlimited investments

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

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

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

2. **High credit worthiness banks and building societies.** See paragraph 7 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.

Objectives of each type of investment instrument

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

1. DEPOSITS

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

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

b) **Term deposits with high credit worthiness banks and building societies.** See paragraph 7 for an explanation of this authority's definition of high credit worthiness. This is the most widely used form of investing used by local authorities. It offers a much higher rate of return than the DMADF (dependent on term) and now that measures have been put in place to avoid over reliance on credit ratings, the authority feels much more confident that the residual risks around using such banks and building societies are at a low, reasonable and acceptable level. The authority will ensure diversification of its portfolio of deposits. In addition, longer term deposits offer an opportunity to increase investment returns by locking in high rates ahead of an expected fall in the level of interest rates. At other times, longer term rates can offer good value when the markets incorrectly assess the speed and timing of interest rate increases. This form of investing therefore, offers a lot of flexibility and higher earnings than the DMADF. Where it is restricted is that once a longer term investment is made, that cash is locked in until the maturity date.

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

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

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

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

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

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

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

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

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

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

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

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

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

4. SECURITIES ISSUED OR GUARANTEED BY GOVERNMENTS

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

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

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

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

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

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

5. SECURITIES ISSUED BY CORPORATE ORGANISATIONS

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

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

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

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

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

6. OTHER

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

b. Local Authority Mortgage Guarantee Scheme. Authorities who are participating in the Local Authority Mortgage Guarantee Scheme (LAMGS) may be required to place a deposit with the mortgage provider(s) up to the full value of the guarantee. The deposit will be in place for the term of the guarantee i.e. 5 years (with the possibility of a further 2 year extension if the account is 90+ days in arrears at the end of the initial 5 years) - and may have conditions / structures attached. The mortgage provider will not hold a legal charge over the deposit.

7. COUNTERPARTY CRITERIA

Surplus money in the Council's Loans Fund may only be advanced to another UK local authority or government guaranteed institution. In addition to:

1. any bank or financial institution which meets the following criteria:-

(i) It falls into one of the groups of banks or financial institutions and appears in our treasury advisors (Sector) credit rating matrix as approved, specifically a rating of P-1 (or better) from Moodys or a rating of F-1 (or better) from Fitch and has a Moodys Financial Strength Rating of 'C' or greater. Or where the organisations are deemed UK government backed and appear in the credit rating matrix.

(ii) The Council's own bankers.

2. any money market fund that meets the following criteria:-

(i) It is a Sterling denominated fund domiciled within the EU as regulated by the Institutional Money Market Funds Association (IMMFA)

(ii) It falls into one of the groups of banks, financial institutions or insurance companies and the institution concerned has a rating of Aaa from Moody's or a rating of AAAmmf from Fitch or a rating of AAAm with Standard & Poor.

(iii) Investments will be made in Constant Net Asset Value (CNAV) Money Market Funds which offer instant access to funds with same day settlement.

A list of approved counterparties will be maintained by the S95 officer and reviewed weekly in line with the Sector counterparty rating service

Table 1: permitted investments in house – Treasury

1.1 Deposits

	*** Minimum Credit Criteria**	**Liquidity risk**	**Market risk**	**Max % of total investments**	**Max. maturity period**
Debt Management Agency Deposit Facility	--	term	no	**100%**	**6 mths**
Term deposits – local authorities	--	term	no	**100%**	**5 years**
Call accounts – banks and building societies **	as counterparty criteria above	instant	no	**100%**	**n/a**
Term deposits – banks and building societies **	as counterparty criteria above	term	no	**100%**	**12 mths**
Fixed term deposits with variable rate and variable maturities: -Structured deposits.	as counterparty criteria above	term	no	**20%**	**12mnths**

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

	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
UK nationalised banks	as counterparty criteria above	term	no	**100%**	**12 mnths**
Banks nationalised by high credit rated (sovereign rating) countries – non UK	as counterparty criteria above	term	no	**20%**	**3mnths**
Government guarantee (explicit) on ALL deposits by high credit rated (sovereign rating) countries**	as counterparty criteria above	term	no	**20%**	**3mnths**
UK Government support to the banking sector (implicit guarantee) ***	as counterparty criteria above	term	no	**20%**	**3mths**
Fixed term deposits with variable rate and variable maturities: -Structured deposits	as counterparty criteria above	term	no	20%	**3mnths**

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

	*** Minimum Credit Criteria**	**Liquidity risk**	**Market risk**	**Max % of total investments**	**Max. maturity period**
1. Government Liquidity Funds	as counterparty criteria above	instant	No	**50%**	**12mths**
2. Money Market Funds	as counterparty criteria above	instant	No	**50%**	**12mnths**

1.4 Securities issued or guaranteed by governments

	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Treasury Bills	UK sovereign rating	Sale T+1	yes	**20%**	**5 yrs**
UK Government Gilts	UK sovereign rating	Sale T+1	yes	**20%**	**5 yrs**
Bonds issued by multilateral development banks Sovereign bond issues (other than the UK govt)	AAA	Sale T+1 Sale T+1	yes yes	**20%**	**5yrs**
Bonds issued by multilateral development banks	AAA	Sale T+1	yes	**20%**	**5yrs**

1.5 Securities issued by corporate organisations

	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Certificates of deposit issued by banks and building societies covered by UK Government (explicit) guarantee	as counterparty criteria above	Sale T+1	yes	**20%**	**12mths**
Certificates of deposit issued by banks and building societies	as counterparty criteria above	Sale T+1	yes	**20%**	**12mths**
Other debt issuance by UK banks covered by UK Government (explicit) guarantee	as counterparty criteria above	Sale T+3	yes	20%	12 mnths

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

1.6 Other

	* Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Property funds	--	T+4	yes	0%	
Local authority mortgage guarantee scheme.	Special criteria as used for non-treasury reasons	term	no	**n/a**	**5yrs**

Appendix 4 - Treasury Management Practice (TMP1) – Credit and Counterparty Risk Management

East Lothian Council and Common Good Funds Permitted Investments, Associated Controls and Limits

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good Limits
Cash type instruments				
a. Deposits with the Debt Management Account Facility (UK Government) (**Very low risk)**	This is a deposit with the UK Government and as such counterparty and liquidity risk is very low, and there is no risk to value. Deposits can be between overnight and 6 months.	Little mitigating controls required. As this is a UK Government investment the monetary limit is unlimited to allow for a safe haven for investments.	£unlimited, maximum 6 months.	As shown in the counterparty section criteria above.
b. Deposits with other local authorities or public bodies **(Very low risk)**	These are considered quasi UK Government debt and as such counterparty risk is very low, and there is no risk to value. Liquidity may present a problem as deposits can only be broken with the agreement of the counterparty, and penalties can apply. Deposits with other non-local authority	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 and maximum 5 yrs.	As shown in the counterparty section criteria above.

	bodies will be restricted to the overall credit rating criteria.			
c. Money Market Funds (MMFs) **(Very low risk)**	Pooled cash investment vehicle which provides very low counterparty, liquidity and market risk. These will primarily be used as liquidity instruments.	Funds will only be used where the MMFs are Constant Net Asset Value (CNAV), and the fund has a “AAA” rated status from either Fitch, Moody’s or Standard & Poors.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.

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

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good Limits
f. Government Gilts and Treasury Bills **(Very low risk)**	These are marketable securities issued by the UK Government and as such counterparty and liquidity risk is very low, although there is potential risk to value arising from an adverse movement in interest rates (no loss if these are held to maturity.	Little counterparty mitigating controls are required, as this is a UK Government investment. The potential for capital loss will be reduced by limiting the maximum monetary and time exposures.	As shown in the counterparty section criteria above..	As shown in the counterparty section criteria above..
g. Certificates of deposits with financial institutions **(Low risk)**	These are short dated marketable securities issued by financial institutions and as such counterparty risk is low, but will exhibit higher risks than categories (a), (b) and (c) above. There is risk to value of capital loss arising from selling ahead of maturity if combined with an adverse movement in interest rates. Liquidity risk will normally be low.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poors. The selection defaults to the lowest available credit rating to provide additional risk control measures. On day to day investment dealing with this criteria will be further strengthened by the use of additional market intelligence.	As shown in the counterparty section criteria above..	As shown in the counterparty section criteria above..

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

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good Limits
Other types of investments				
j. Investment properties	These are non-service properties which are being held pending disposal or for a longer term rental income stream. These are highly illiquid assets with high risk to value (the potential for property prices to fall or for rental voids).	In larger investment portfolios some small allocation of property based investment may counterbalance/compliment the wider cash portfolio. Property holding will be re-valued regularly and reported annually with gross and net rental streams.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.
k. Loans to third parties, including soft loans	These are service investments either at market rates of interest or below market rates (soft loans). These types of investments may exhibit credit risk and are likely to be highly illiquid.	Each third party loan requires Member approval and each application is supported by the service rational behind the loan and the likelihood of partial or full default.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.
l. Loans to a local authority company	These are service investments either at market rates of interest or below market rates (soft loans). These types of investments may exhibit credit risk and are likely to be highly illiquid.	Each loan to a local authority company requires Member approval and each application is supported by the service rational behind the loan and the likelihood of partial or full default.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.
m. 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.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good Limits
n. 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.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.

The Monitoring of Investment Counterparties - The status of counterparties will be monitored regularly. The Council receives credit rating and market information from Sector, including when ratings change, and counterparties are checked promptly. On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the S95 officer, and if required new counterparties which meet the criteria will be added to the list.

Use of External Fund Managers – It is the Council's current policy to use external fund managers for the Common Good Funds. The fund managers are contractually committed to keep to the Council's investment strategy. The terms of the fund managers' investment policies can be reviewed by contacting the S95 officer The performance of each manager is reviewed at least annually by the S95 officer and the manager is contractually required to comply with the annual investment strategy.

APPENDIX 5 Approved countries for investments

Based on lowest available rating

AAA

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

AA+

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

AA

- Belgium
- Qatar
- UAE

AA-

- Japan
- Saudi Arabia

APPENDIX 6 Treasury management scheme of delegation

(i) Full board/council

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

(ii) Boards/committees/council/responsible body

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

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

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

APPENDIX 7 The treasury management role of the section 95 officer

The S95 (responsible) 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.