The Highland Council

13 March 2014

Agenda Item	15
Report No	HC/66/13

Treasury Management Strategy Statement and Investment Statement – 2014/15

Report by Director of Finance

Summary

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 Statement to be approved by Council for the forthcoming financial year.

In compliance with the Code, the attached Treasury Management Strategy Statement and Investment Statement for 2014/15 was submitted to Finance, Housing and Resources Committee for scrutiny on 26 February 2014 and is now submitted to the Council for approval.

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 in Section 10 of this report); this 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 4th March 2010. The Code was further updated in November

2011.

The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
3. 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.
4. 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.
5. 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 Finance, Housing and Resources Committee.

1.4 Treasury Management Strategy for 2014/15

The proposed strategy for 2014/15 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, Capita.

The strategy covers:

- treasury limits for 2014/15 to 2016/17 (which will limit the treasury risk and activities of the Council);
- the current treasury position;
- the borrowing requirement, based upon the Council's current capital programmes;
- Prudential and Treasury Indicators;
- prospects for interest rates;
- the borrowing strategy (including policy on borrowing in advance of need);
- debt rescheduling;
- annual investment strategy.

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 the following, are limited to a level which is affordable within the projected income of the Council for the foreseeable future:

- increases in interest charges caused by increased borrowing to finance additional capital expenditure; and
- any increases in running costs from new capital projects.

1.6 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 (the FHR Committee). In August 2013, a training workshop was held which was well attended by Members and Officers. This covered key Treasury Management theory, outlining the regulatory and legislative requirements and provided practical worked examples of treasury management scenarios.

The training needs of treasury management officers are periodically reviewed, with training provided throughout the year using a number of mediums; in-house training, meetings with and training provided by Treasury advisers, external training courses, attendance at treasury forum meetings with other Councils.

1.7 Treasury management advisors

The Council uses Capita as its external treasury management advisors. The current contractual arrangement will end on 30 June 2014, based on agreement by the previous Council's Resources Committee to utilise the optional 1 year contract extension to that date. A new tendering exercise will take place for services commencing 1 July.

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 subjected to regular review.

The Council also 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.

2. Treasury Limits for 2014/15 to 2016/17

2.1 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.

2.2 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'.

2.3 Whilst termed an "Affordable Capital Expenditure Limit", the capital plans to be considered for inclusion may 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.

2.4 The Council's current General Fund capital programme was agreed in June 2013. The Housing Revenue Account capital programme reflects the updated Scottish Housing Quality Standard delivery plan reported to members in October 2013, and current new build programme.

3. Current Treasury Position

3.1 For information and contextual purposes, the Council's treasury portfolio position at the most recent month end (31 December 2013) is as shown below, including a comparison with the equivalent prior year. Both debt (borrowing) and investments show a year on year decrease in the average interest rate over that period.

Table 1 – Current Treasury Position

	At 31 Dec 2013		**At 31 Dec 2012**		**Year on Year**	
	Balance £m	**Avg. Rate (%)**	**Balance £m**	**Avg. Rate (%)**	**Balance £m**	**Avg. Rate (%)**
1.Debt:						
a.Fixed Interest Rate						
PWLB	550.4	5.04	529.1	5.07	+21.3	-0.03
Market	85.4	0.79	52.5	2.26	+32.9	-1.47
b.Variable Interest Rate						
PWLB	0	0	0	0	0	0
Market	92.3	5.07	92.3	5.07	0	0
Total Debt	**728.1**	**4.54**	**673.9**	**4.85**	**+54.2**	**-1.47**

2.Investments:						
Fixed Interest Rate	32.6	0.80	11.0	1.85	+21.6	-1.05
Variable Interest Rate	65.2	0.48	57.5	0.60	+7.7	-0.12
Total Investments	**97.8**	**0.59**	**68.5**	**0.80**	**+29.3**	**-1.17**

4. Borrowing Requirement

4.1 The following table sets out the borrowing requirement, showing past/current year, as well as estimates for future years. The borrowing requirement takes account of borrowing to support the agreed capital programmes, less the projected instalments as capital repayments are charged to revenue accounts through loan charges. This figure is then adjusted to take account of any further borrowing required to go towards the capital financing requirement, or to replace existing loans maturing in these years.

Table 2 – Borrowing Requirement (current year and next 3 years)

	2012/13 Actual	2013/14 Est. outturn	2014/15 Est-imate	2015/16 Est-imate	2016/17 Est-imate
New borrowing for capital (net Capital Programme less estimated instalments)	£24.2m	£54.6m	£69.9m	£49.3m	£20.4m
Additional long term borrowing towards Capital Financing Requirement	0	0	0	0	0
Loan Maturities - Replacement Borrowing	£10.0m	£17.5m	£10.0m	£21.7m	£20.8m
Total Long Term Borrowing Requirement	£34.2m	£72.1m	£79.9m	£71.0m	£41.2m

5. Prudential and Treasury Indicators

5.1 Prudential and Treasury Indicators as set out in **Appendix 2** to this report and are relevant for the purposes of setting an integrated treasury management strategy. These Indicators are based on the Council's current capital programme including the updated General Fund programme from June 2013.

5.2 The Council is also required to indicate if it has adopted the CIPFA Code of Practice on Treasury Management. The original 2001 Code was adopted in February 2002 and the revised 2009 Code was adopted on by the Council on 4 March 2010. The Code was further updated in November 2011, and it is recommended the Council continues to adopt the Code.

6. Economic Context and Prospects for Interest Rates

6.1 The Council has appointed Capita as treasury advisor to the Council and part of their service is to assist the Council to formulate a view on interest rates and longer fixed interest rates. The following table gives the Capita central view.

Table 3 – Capita view of interest rates (as at 20/01/14)

Annual Average %	Bank Rate	PWLB Borrowing Rates (including certainty rate adjustment)		
		5 year	25 year	50 year
Dec 2013	0.50	2.50	4.40	4.40
March 2014	0.50	2.50	4.40	4.40
June 2014	0.50	2.60	4.50	4.50
Sept 2014	0.50	2.70	4.50	4.50
Dec 2014	0.50	2.70	4.60	4.60
March 2015	0.50	2.80	4.60	4.70
June 2015	0.50	2.80	4.70	4.80
Sept 2015	0.50	2.90	4.80	4.90
Dec 2015	0.50	3.00	4.90	5.00
March 2016	0.50	3.10	5.00	5.10
June 2016	0.75	3.20	5.10	5.20
Sept 2016	1.00	3.30	5.10	5.20
Dec 2016	1.00	3.40	5.10	5.20
March 2017	1.25	3.40	5.10	5.20

6.2 There is risk to these forecasts if recovery from the economic downturn proves to be weaker and slower than currently expected or conversely, recovery is quicker than expected. The UK unemployment levels have already dropped at a faster pace than had been forecast, however, the Bank of England is expected to amend its forward guidance, with it unlikely there is an imminent ‘trigger’ in an increase in bank rate. A detailed view of the current economic background is contained within **Appendix 3** to this report.

6.3 The current economic outlook and structure of market interest rates and government debt yields have several key treasury management implications:

- In relation to the Eurozone, concerns have subsided considerably in 2013. However, sovereign debt difficulties have not gone away and major concerns could return in respect of any countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise to levels that could result in a loss of investor confidence in the financial viability of such countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed. Counterparty risks therefore remain elevated. This continues to suggest the use of higher quality counterparties for shorter time periods;
- Investment returns are likely to remain relatively low during 2014/15 and beyond;
- Borrowing interest rates have risen significantly during 2013 and are on a rising trend. The policy of avoiding new borrowing by running down spare cash balances, or using short-term borrowing, has served well over the last few years while rates have remained low. However, this position will need reviewed going forward, with the prospect of rising interest rates and increased costs to finance new

capital expenditure and/or to refinance maturing debt, in the near future. The strategy set out within this report responds to these risks;

- There will remain a ‘cost of carry’ to any new borrowing which causes an increase in investments as this will incur a revenue loss , being the differential between borrowing costs and investment returns.

6.4 The outcome of the forthcoming independence referendum vote, may also give rise to matters which need to be considered in the context of future treasury strategies, and will be considered as part of the development of the 2015/16 strategy later this year.

7. Context

7.1 Since the consideration of the last Treasury and Investment Strategy in early 2013, there are some matters relating to the Council’s strategies and external environment that are highlighted below for context.

- Investment counter-parties – Money Market Funds

  The Council continues to use Money Market Funds (MMF) as part of its Investment counter-party strategy which are a permitted counter-party in accordance with the 2013/14 (and this 2014/15) strategy. As a result, the Council has not had to use the HM Treasury Debt Management Office (DMO) where the returns available were significantly below that available through other options within the Council’s risk appetite.

  However, the European Commission has now issued proposals relating to MMFs which are expected to alter the risk profile of these funds, as well as the liquidity and return levels. These changes are unlikely to be finalised until mid-2015 at the earliest, therefore giving scope for consideration as part of the 2015/16 TMSS.

- Investment counter-parties – Government Backed Banks

  The UK Government has already commenced disposal of some of its holding in Lloyds, and long-term clearly the expectation is both Lloyds and RBS are returned fully to the private sector. In the short to medium term there is no expectation of Government support altering or reducing, however, future annual strategies would review the Council’s counter-party approach when it became clear any implications in relation to risk.

- Investment counter-parties – Other UK Banks

  During the year, the credit ratings for Barclays and Santander were upgraded and rated green (Capita recommend maximum deposits duration is 100 days). Following a period of keeping these counter parties on review to ensure their green rating was stable, the Council has now utilised call accounts with these counter-parties, expanding the number of call accounts available.

- Police and Fire debt

  An agreement was signed between the Council and Police Scotland and the Scottish Fire and Rescue Service in April 2013, setting out the arrangements for the repayment of historic Police and Fire debt by these organisations. There is now a process whereby the Council provides Police and Fire with an estimate of debt charges in December for the following year which is invoiced in two instalments in March and September.

- PWLB Certainty Rate

  The PWLB certainty rate which was introduced in 2012 continues to apply. A 0.20% discount in existing PWLB borrowing rates was available for Councils who were willing to provide HM Treasury with future forecasts of their borrowing requirements. The Council submitted the necessary forecasts and can now benefit from the discount. Entry into the certainty rate arrangement does not commit, nor limit the Council, to a notified level of borrowing.

8. Borrowing Strategy

8.1 Over the past few years the Council has benefitted from lower borrowing costs due to low interest rates, in particular temporary borrowing and internal borrowing (use of existing cash). However, as reflected earlier in this report longer-term prospects are for a rise in interest rates. With this in mind, the Council's borrowing strategy for 2014/15 will give increasing consideration to a strategy of de-risking by taking longer-term borrowing, with the aim of mitigating the risk of increased borrowing costs as interest rates start to rise. The Council will however ensure its strategy remains flexible, and will give consideration to new borrowing from the following sources based on prevailing market conditions:

1. In view of the overall forecast for long term borrowing rates to increase over the next few years, consideration will be given to a strategy of utilising PWLB borrowing with a medium to long-term maturity, to de-risk re-financing costs in future years. This strategy will potentially lead to higher borrowing costs in the short-term, and a 'cost of carry', than could otherwise be achieved, but would be done to reduce the risk of higher costs over the longer-term.
2. Temporary borrowing from the money markets or other local authorities.
3. PWLB variable rate loans for up to 10 years.
4. Short dated borrowing from non PWLB below sources.
5. Long term fixed rate market loans at rates significantly below PWLB rates for the equivalent maturity period (where available) and to maintaining an appropriate balance between PWLB and market debt in the debt portfolio.
6. Consideration of any government supported or promoted lending initiatives, which may offer attractive sources of finance e.g. low cost borrowing for specific energy efficiency projects.
7. PWLB borrowing (including for periods under 10 years where rates are expected to be lower than rates for longer periods). This offers a range of options for new borrowing which will spread debt maturities away

from a concentration in longer dated debt.

8.2 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.

8.3 External v. Internal Borrowing

As reflected in the table below, the Council's objective is to maintain a level of temporary investments which will ensure a level of liquid cash available to the Council. The level shown takes account of the level of Council reserves and balances, and potential for these to be utilised through planned use or unforeseen events. Through this approach, the Council seeks to mitigate re-financing risk, particularly were the Council's reserves to be eroded due to unforeseen events.

Table 4 – Comparison of gross and net debt positions at year end

	2012/13 Actual	**2013/14 Est outturn**	**2014/15 Est-imate**	**2015/16 Est-imate**	**2016/17 Est-imate**
External Debt (gross)	£685.1m	£739.6m	£809.5m	£858.8m	£879.2m
Temporary Investments	£75.8m	£60.0m	£60.0m	£60.0m	£60.0m
External Debt (net)	**£609.3m**	**£679.6m**	**£749.5m**	**£798.8m**	**£819.2m**

Table excludes long-term liabilities e.g. PPP schemes

- Another factor in considering the level of investments held, is the difference between borrowing rates and investment rates to ensure the Council obtains value for money once an appropriate level of risk management has been attained to ensure the security of its investments and mitigating of re-financing risk.
- The expectation is for continuing low bank rates for deposits in 2014/15, therefore the Council will keep its range of available counter-parties under regular review, to maximise value for money

considerations. However, as clearly stated within this strategy, the priorities for the Council's investments are security and liquidity first, and only then looking at investment yield.

Given continued uncertainty relating to the economic outlook, the Council will continue to adopt a cautious approach in relation to its treasury operations.

The Director of Finance will monitor the interest rate market, take advice from professional advisors, and adopt a pragmatic approach to changing circumstances, reporting any decisions to the Finance, Housing and Resources Committee at the next available opportunity.

8.4 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. In accordance with the revised Code, any decision to borrow in advance will be within the 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.

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 prevailing and projected interest rates based on best available information.
- Consider appropriate maturity profiles of new borrowing.
- 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.

The maximum extent to which borrowing in advance would be undertaken will be based upon the existing and projected capital financial requirement, and existing level of debt.

9. Debt Rescheduling

9.1 At this time, and due to the early repayment penalties imposed by PWLB, there are limited opportunities for debt rescheduling. However, this position will be kept under regular review.

9.2 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 strategy outlined in section 8 above, and
- to enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

9.3 Consideration will also be given to the 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 FHR Committee, at the earliest meeting following its action.

10. Annual Investment Strategy

10.1 <u>Investment Policy</u>

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.**

The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of this Council is low in order to give priority to security of its investments.

The borrowing of monies purely to invest or on-lend and make a return is unlawful and this Council will not engage in such activity.

The Council's policy in relation to Investment instruments and counter-parties identified for use in the financial year are listed in **Appendices 4, 5 and 6** and explanatory notes on investment types and risks are detailed in **Appendix 7**.

10.2 <u>Creditworthiness policy</u>

The Council recognises the vital importance of credit-worthiness checks on the counter-parties it uses for investments, and as described above the Council has a low risk appetite in relation to investments.

This Council uses the creditworthiness service provided by Capita Treasury Services. This service employs a sophisticated modelling approach with credit ratings from all three rating agencies - Fitch, Moodys and Standard and Poors. The credit ratings of counterparties are supplemented with further credit overlays to provide a colour coded system based on recommended durational band for use of the counter-party.

This Council does not use the approach suggested by CIPFA of using the lowest rating from all three rating agencies to determine creditworthy counterparties. The Capita creditworthiness service uses a wider array of information than just primary ratings, from all three agencies, but by using a risk weighted scoring system, does not give undue preponderance to just one agency's ratings.

The Capital creditworthiness service is used on an advisory basis, with the decision on creditworthiness ultimately resting with officers.

10.3 Foreign Exposures/Country limits

In relation to Money Market Funds, only AAA rated Sterling denominated funds will be used.

In relation to all other counter-parties, the Council will only use UK based institutions. For example UK banks and building societies, UK Local Authorities, HMT Treasury Debt Management Office.

Appendices 4, 5, 6 and 7 set out further details on the Council's permitted investments and approach to use of counter-parties.

10.4 Investment Strategy

In-house funds are mainly cash-flow derived and investments will be made in accordance with cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

10.5 Investment return expectations

As detailed in section 6, Table 3 Capita view of interest rates, Bank Rate is forecast to remain unchanged at 0.50% before starting to rise from quarter 2 of 2016. Bank Rate forecasts (as at 20/01/14) for financial year ends (March) are:

- 2013/2014 0.50%
- 2014/2015 0.50%
- 2015/2016 0.50%
- 2016/2017 1.25%

There are upside risks to these forecasts (i.e. start of increases in Bank Rate occurs sooner) if economic growth remains strong and unemployment falls faster than expected. However, should the pace of growth fall back, there could be downside risk.

The suggested budgeted investment earnings rates for returns on investments placed for periods up to 100 days during each financial year for the next four years are as follows (as at 20/01/14):

- 2014/15 0.50%
- 2015/16 0.50%
- 2016/17 1.00%
- 2017/18 2.00%

The Council will avoid locking into longer term deals while investment rates are down at historically low levels unless attractive rates are available with counterparties of particularly high creditworthiness which make longer term deals worthwhile and within the risk parameters set by this Council.

10.6 For its cashflow generated balances, the Council will seek to utilise its business reserve accounts, 15 and 30 day notice accounts, short-dated deposits and money market funds in order to benefit from the compounding of interest.

10.7 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.

Forecasts of investment balances for the next three years are provided in **Appendix 8**.

10.8 Policy on the Use of External Service Providers

The Council's tendered Treasury Management advisor contract is subject to regular review. The Council currently uses Capita Treasury Services as its external treasury management advisers. 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.

10.9 Treasury Management Scheme of Delegation

Please see **Appendix 9**.

10.10 The Treasury Management Role of Section 95 Officer

Please see **Appendix 9**.

11. Implications

11.1 The resource and risk implications are covered in the attached tables. There are no specific legal, equality or climate change/Carbon Clever implications relating to this report.

Recommendation

In compliance with the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management in Local Authorities, the attached Treasury Management Strategy Statement and Investment Statement for 2014/15 is submitted to Council for approval.

Designation: Director of Finance

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Date: 3 March 2014

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Appendices

1. Interest Rate Forecasts
2. Prudential and Treasury Indicators
3. Economic Background
4. Permitted Investments – Treasury Investments
5. Permitted Investments – Common Good, Charitable, Educational and Other Trust Funds
6. Permitted Investments – Non Treasury Investments
7. Current counter party list as at 27/01/2014
8. Treasury Management Practice 1 (TMP1) Credit and Counterparty Risk Management
9. Treasury Management Scheme of Delegation and Role of the Section 95 Officer

Appendix 1

Interest Rate Forecasts 2014 to 2017 (provided by Capita as at 13/01/14)

Bank Rate	NOW	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Capita Asset Services	**0.50%**	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.00%	1.25%
UBS	**0.50%**	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	-	-	-	-	-
Capital Economics	**0.50%**	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	-	-	-	-	-

5yr PWLB Rate	NOW	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Capita Asset Services	**2.63%**	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.40%
UBS	**2.63%**	-	-	-	-	-	-	-	-	-	-	-	-	-
Capital Economics	**2.63%**	2.60%	2.60%	2.60%	2.60%	2.70%	2.80%	3.00%	3.20%	-	-	-	-	-

10yr PWLB Rate	NOW	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Capita Asset Services	**3.72%**	3.60%	3.70%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.20%	4.30%	4.30%	4.40%	4.50%
UBS	**3.72%**	3.70%	3.80%	3.90%	4.05%	4.05%	4.30%	4.55%	4.55%	-	-	-	-	-
Capital Economics	**3.72%**	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	4.05%	-	-	-	-	-

25yr PWLB Rate	NOW	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Capita Asset Services	**4.35%**	4.40%	4.50%	4.50%	4.60%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.10%	5.10%	5.10%
UBS	**4.35%**	4.55%	4.55%	4.80%	4.80%	5.05%	5.05%	5.30%	5.30%	-	-	-	-	-
Capital Economics	**4.35%**	4.35%	4.35%	4.35%	4.35%	4.35%	4.35%	4.35%	4.45%	-	-	-	-	-

50yr PWLB Rate	NOW	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Capita Asset Services	**4.31%**	4.40%	4.50%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.20%	5.20%	5.20%
UBS	**4.31%**	4.45%	4.45%	4.70%	4.70%	4.90%	4.90%	5.05%	5.05%	-	-	-	-	-
Capital Economics	**4.31%**	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.60%	-	-	-	-	-

Appendix 2

Prudential and Treasury Indicators

The borrowing set out within the Prudential Indicators is based upon the General Fund capital programme agreed by the Council in June 2013.
In relation to the HRA, borrowing is as per the Scottish Housing Quality Standard Delivery Plan updated, plus agreed new build programme.
The Estimates of Capital Expenditure below in indicator 3 and 4 include expenditure in relation to the National Housing Trust which is self-financing.

A. Indicators for Affordability, Prudence and Capital Expenditure

Indicator 1 - Capital Expenditure

Gross Capital Expenditure in absolute terms rather than as a ratio, these show the overall levels of estimated capital investment irrespective of how they are being funded.

	2012/13 Actual	2013/14 Original Estimate	2013/14 Revised Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
General Fund	£77.2m	£73.9m	£96.6m	£96.2m	£117.5m	£78.1m
Housing Revenue Account	£32.9m	£30.3m	£41.0m	£70.6m	£32.7m	£23.9m
Total	**£110.1m**	**£104.2m**	**£137.6m**	**£166.8m**	**£150.2m**	**£102.0m**

Net Capital Expenditure is the borrowing or funding requirement for new capital investment in each year.

General Fund	£32.8m	£44.2m	£61.6m	£53.8m	£70.4m	£47.5m
Housing Revenue Account	£21.7m	£19.9m	£27.9m	£52.9m	£17.4m	£12.7m
Total	**£54.5m**	**£64.1m**	**£89.5m**	**£106.7m**	**£87.8m**	**£60.2m**

Indicator 2 – Capital Financing Requirement (CFR)

These indicators represent the level of the Council's underlying need to borrow or finance by other long-term liabilities for a capital purpose. This includes past and future borrowing or funding.

	2012/13 Actual	2013/14 Original Estimate	2013/14 Revised Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
General Fund excluding PPP	£513.8m	£544.5m	£548.2m	£573.2m	£614.2m	£631.1m
PPP	£133.0m	£129.5m	£129.5m	£125.9m	£122.0m	£118.2m
Total	**£646.8m**	**£674.0m**	**£677.7m**	**£699.1m**	**£736.2m**	**£749.3m**
Housing Revenue Account	£161.4m	£181.5m	£183.1m	£229.0m	£238.4m	£242.9m
Total	**£808.2m**	**£855.5m**	**£860.8m**	**£928.2m**	**£974.6m**	**£992.2m**
Joint Boards	£25.8m	£24.1m	£24.3m	£23.2m	£22.2m	£21.2m
Total CFR (incl Police/Fire) (1)	**£834.0m**	**£879.6m**	**£885.1m**	**£951.4m**	**£996.8m**	**£1,013.4m**

Treasury Position This indicator shows the expected borrowing position, net of investments.

Gross Borrowing	£685.0m	£728.1m	£739.6m	£809.5m	£858.8m	£879.2m
Other Long Term Liabilities	£133.0m	£129.5m	£129.5m	£125.9m	£122.0m	£118.2m
Total Gross Debt (2)	**£818.0m**	**£857.6m**	**£869.1m**	**£935.4m**	**£980.8m**	**£997.4m**
Investments	£75.7m	£50.0m	£60.0m	£60.0m	£60.0m	£60.0m
Net Borrowing	**£742.3m**	**£807.6m**	**£809.1m**	**£875.4m**	**£920.8m**	**£937.4m**

Difference between CFR (1) and Total Gross Debt (2)

This indicator shows the difference between the Capital Financing Requirement, and the Estimated Gross Debt. The difference represents an ‘under-borrowed’ position, with capital financed from internal cashflows.

	2012/13 Actual	2013/14 Original Estimate	2013/14 Revised Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Difference between CFR (1) and Total Gross Debt (2)	£16.0m	£22.0m	£16.0m	£16.0m	£16.0m	£16.0m

Indicator 3 – Authorised Limit for Borrowing

The Authorised Limit is the maximum level of external borrowing which should not be exceeded. The limit is linked to the estimated level of capital financing requirement, with some capacity for variations from that sum e.g. if capital expenditures are exceeded.

Authorised Limit	2012/13 Actual	2013/14 Original Estimate	2013/14 Revised Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Borrowing	£877.6m	£846.1m	£916.5m	£916.5m	£916.5m	£916.5m
Other Long Term Liabilities	£133.0m	£129.5m	£142.5m	£138.5m	£134.1m	£130.0m

Indicator 4 - Operational Boundary for Borrowing

An Operational Boundary is also required which represents the Director of Finance’s estimate of the day to day limit for the Treasury Management activity based on the most likely i.e. prudent but not worst case scenario.

Operational Boundary	2012/13 Actual	2013/14 Original Estimate	2013/14 Revised Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Borrowing	£848.8m	£773.1m	£773.1m	£854.5m	£888.8m	£879.3m
Other Long Term Liabilities	£133.0m	£129.5m	£129.5m	£125.9m	£121.9m	£118.2m

Indicator 5 – Ratio of financing costs to net revenue stream

These indicators show the capital financing costs (interest charges, the provision for the repayment of debt and the financing of PPP outstanding capital investment liability) as a percentage of government grant (revenue), Council Tax, Rents and other income. This allows the authority to track how much of its annual income is needed to pay for its capital investment plans and outstanding funding liabilities compared to its day to day running costs.

	2012/13 Actual	2013/14 Original Estimate	2013/14 Revised Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
General Fund including PPP	11.4%	10.1%	12.1%	12.6%	13.1%	13.6%
Housing Revenue Account	30.4%	31.4%	31.8%	35.5%	39.1%	40.3%

Indicator 6 – Estimates of the Incremental impact of capital investment decisions on the Band D Council tax and housing rents levels

These indicators demonstrate the **notional** impact of varying new capital investment expressed as a cost on the Band D Council Tax and Rents. These are notional rather than actual increases in Council Tax and rent, as the Council has or will utilise savings and other measures to fund its capital plans, to minimise the impact on tax and rent levels.

	2012/13 Actual	2013/14 Original Estimate	2013/14 Revised Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Estimates of the Incremental impact of capital investment decisions on the Band D Council tax		£38.68	£25.03	£38.53	£37.87	£38.53
Estimates of the Incremental impact of capital investment decisions on the housing rent levels (weekly figures based on a 48 week year are shown in brackets)		£112.62 (£2.35)	£81.95 (£1.71)	£174.90 (£3.64)	£193.08 (£4.02)	£60.54 (£1.26)

Indicator 7- Interest rate exposures of debt net of investments

Interest rate exposures of debt net of investments are required to be set in compliance with the Code. This limits the Council's exposure to both fixed and variable interest rate movements as part of the overall risk management strategy for Treasury Management activities. It promotes a prudent strategy aimed to avoid the adverse effects of fluctuating interest rates. The limits are based on the Capital Financing Requirement with variable exposures limited to 35% of fixed.

Interest rate exposures of debt net of investments	2012/13 Actual	2013/14 Original Estimate	2013/14 Revised Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Upper Limit (Fixed)	£573.6m	£750.1m	£755.6m	£825.5m	£874.8m	£895.2m
Upper Limit (Variable)	£67.6m	£262.5m	£264.5m	£288.9m	£306.2m	£313.3m

Maturity structure of fixed rate borrowing during 2014/15

This indicator identifies the amount of debt maturing in specified periods. The overarching principle is that steps should be taken from a risk management point of view to limit exposure to significant refinancing risk in any short period of time. The Council currently applies the prudent practice of ensuring that no more than 30% of its total gross fixed rate debt matures in any one financial year unless triggered through specific debt restructuring exercises.

	upper limit	lower limit
under 12 months	30%	0%
12 months and within 24 months	30%	0%
24 months and within 5 years	30%	0%
5 years and within 10 years	50%	0%
10 years and above	100%	25%

Maximum principal invested for period longer than 364 days

The maximum total principal sum which may be invested with a maturity for a period longer than 364 days and within the permitted investment limits is £20m

Compliance with other prudential indicators

In addition to the above, the Council is required as a Prudential Indicator to:

- Adopt the CIPFA Code of Practice.
- Ensure that over the medium term borrowing will only be for a capital purposes (i.e. net external borrowing is less than the CFR)

The compliance with these indicators is highlighted in the body of the report.

The above indicators have been set to contain the Council's exposure to the possibility of loss that might arise as a result of having to seek early redemption of principal sums invested over the longer term.

The Council's current investment strategy is to maintain only temporary, shorter-term investments for portfolio management purpose. This affords operational flexibility and enables returns to be compounded more frequently.

Appendix 3

Economic Background Provided by Capita Treasury Services (as at 20/01/14)

The UK economy

Economic growth

Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth strongly rebounded in 2013 - quarter 1 (+0.3%), 2 (+0.7%) and 3 (+0.8%), to surpass all expectations as all three main sectors, services, manufacturing and construction contributed to this strong upturn. The Bank of England has, therefore, upgraded growth forecasts in the August and November quarterly Inflation Reports for 2013 from 1.2% to 1.6% and for 2014 from 1.7% to 2.8%, (2015 unchanged at 2.3%). The November Report stated that: -

In the United Kingdom, recovery has finally taken hold. The economy is growing robustly as lifting uncertainty and thawing credit conditions start to unlock pent-up demand. But significant headwinds — both at home and abroad — remain, and there is a long way to go before the aftermath of the financial crisis has cleared and economic conditions normalise. That underpins the MPC's intention to maintain the exceptionally stimulative stance of monetary policy until there has been a substantial reduction in the degree of economic slack. The pace at which that slack is eroded, and the durability of the recovery, will depend on the extent to which productivity picks up alongside demand. Productivity growth has risen in recent quarters, although unemployment has fallen by slightly more than expected on the back of strong output growth.

Forward surveys are currently very positive in indicating that growth prospects are also strong for 2014, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. This is very encouraging as there does need to be a significant rebalancing of the economy away from consumer spending to construction, manufacturing, business investment and exporting in order for this start to recovery to become more firmly established. One drag on the economy is that wage inflation continues to remain significantly below CPI inflation so disposable income and living standards are under pressure, although income tax cuts have ameliorated this to some extent. This therefore means that labour productivity must improve significantly for this situation to be corrected by the warranting of increases in pay rates.

Forward guidance

The Bank of England issued forward guidance in August which stated that the Bank will not start to consider raising interest rates until the jobless rate (Labour Force Survey / ILO i.e. not the claimant count measure) has fallen to 7% or below. This would require the creation of about 750,000 jobs and was forecast to take three years in August, but revised to possibly quarter 4 2014 in November. The UK unemployment rate has already fallen to 7.1% on the three month rate to December 2013 (although the rate in October alone was actually 7.0%). The Bank's guidance is subject to three provisos, mainly around inflation; breaching any of them would sever the link between interest rates and unemployment levels. This actually makes forecasting Bank Rate much more complex given the lack of available reliable forecasts by economists over a three year plus horizon. The recession since 2007 was notable for how unemployment did NOT rise to the levels that would normally be expected in a major recession and the August Inflation Report noted that productivity had sunk to 2005 levels. There has, therefore, been a significant level of retention of labour, which will mean that there is potential for a significant amount of GDP growth to be accommodated without a major reduction in unemployment. However, it has been particularly encouraging that the strong economic growth in 2013 has also been accompanied by a rapid increase in employment and forward hiring indicators are also currently very positive. It is therefore increasingly likely that early in 2014, the MPC will need to amend its forward guidance by reducing its 7.0% threshold rate and/or by adding further wording similar to the Fed's move in December (see below).

Credit conditions

While Bank Rate has remained unchanged at 0.5% and quantitative easing has remained unchanged at £375bn in 2013, the Funding for Lending Scheme (FLS) was extended to encourage banks to expand lending to small and medium size enterprises. The second phase of Help to Buy aimed at supporting the purchase of second hand properties, will also start in earnest in January 2014. These measures have been so successful in boosting the supply of credit for mortgages, and so of increasing house purchases, (though levels are still far below the pre-crisis level), that the Bank of England announced at the end of November that the FLS for mortgages would end in February 2014. While there have been concerns that these schemes are creating a bubble in the housing market, house price increases outside of London and the south-east have been much weaker. However, bank lending to small and medium enterprises continues to remain weak and inhibited by banks still repairing their balance sheets and anticipating tightening of regulatory requirements.

Inflation

Inflation has fallen from a peak of 3.1% in June 2013 to 2.1% in November. It is expected to remain near to the 2% target level over the MPC's two year time horizon.

AAA rating

The UK has lost its AAA rating from Fitch and Moody's but that caused little market reaction.

Capita's forward view

Economic forecasting remains difficult with so many external influences weighing on the UK. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, and safer bonds.

There could well be volatility in gilt yields over the next year as financial markets anticipate further tapering of asset purchases by the Fed. The timing and degree of tapering could have a significant effect on both Treasury and gilt yields. Equally, while the political deadlock and infighting between Democrats and Republicans over the budget has almost been resolved the raising of the debt limit, has only been kicked down the road. A final resolution of these issues could have a significant effect on gilt yields during 2014.

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 of bond issuance in other major western countries. Increasing investor confidence in economic recovery is also likely to compound this effect as a continuation of recovery will further encourage investors to switch back from bonds to equities.

The overall balance of risks to economic recovery in the UK is currently evenly weighted. However, only time will tell just how long this period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

The interest rate forecasts in this report are based on an initial assumption that there will not be a major resurgence of the EZ debt crisis, or a break-up of the EZ, but rather that there will be a managed, albeit painful and tortuous, resolution of the debt crisis where EZ institutions and governments eventually do what is necessary - but only when all else has been tried and failed. Under this assumed scenario, growth within the EZ will be tepid for the next couple of years and some EZ countries experiencing low or negative growth, will, over that time period, see a significant increase in total government debt to GDP ratios. There is a significant danger that these ratios could rise to the point where markets lose confidence in the financial viability of one, or more, countries. However, it is impossible to forecast whether any individual country will lose such confidence, or when, and so precipitate a resurgence of the EZ debt crisis. While the ECB has adequate resources to manage a debt crisis in a small EZ country, if one, or more, of the large countries were to experience a major crisis of market confidence, this would present a serious challenge to the ECB and to EZ politicians.

Downside risks currently include:

- UK strong economic growth is currently very dependent on consumer spending and recovery in the housing market. This is unlikely to endure much beyond 2014 as most consumers are maxed out on borrowing and wage inflation is less than CPI inflation, so disposable income is being eroded.
- A weak rebalancing of UK growth to exporting and business investment causing a major weakening of overall economic growth beyond 2014
- Weak growth or recession in the UK's main trading partners - the EU and US, depressing economic recovery in the UK.
- Prolonged political disagreement over the raising of the US debt ceiling.
- A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations.
- A resurgence of the Eurozone sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and Eurozone governments to deal with the potential size of the crisis.
- The potential for a significant increase in negative reactions of populaces in Eurozone countries against austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.
- The Italian political situation is frail and unstable; this will cause major difficulties in implementing austerity measures and a programme of overdue reforms. Italy has the third highest government debt mountain in the world.
- Problems in other Eurozone heavily indebted countries (e.g. Cyprus and Portugal) which could also generate safe haven flows into UK gilts, especially if it looks likely that one, or more countries, will need to leave the Eurozone.
- A lack of political will in France, (the second largest economy in the EZ), to dynamically address fundamental issues of low growth, poor international uncompetitiveness and the need for overdue reforms of the economy.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- Geopolitical risks e.g. Syria, Iran, North Korea, which could trigger safe haven flows back into bonds.

The potential for upside risks to UK gilt yields and PWLB rates, especially for longer term PWLB rates include:

- A sharp upturn in investor confidence that sustainable robust world economic growth is firmly expected, causing a surge in the flow of funds out of bonds into equities.
- A reversal of Sterling's safe-haven status on a sustainable improvement in financial stresses in the Eurozone.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.
- In the longer term – an earlier than currently expected reversal of QE in the UK; this could initially be implemented by allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held.

Appendix 4

Permitted Investments – Common Good, Charitable, Educational and Other Trust Funds

The Council approves the following forms of investment instruments for use as permitted investments for these Funds as set out in the Table below (these include internally and externally managed funds):

Investments

<table>
<tr><th></th><th>Minimum Credit Criteria</th><th>Liquidity risk</th><th>Market risk</th><th>Max % of total investment</th><th>Max. maturty period</th></tr>
<tr><td>Cash deposits – local authorities, banks, building societies and cash funds</td><td rowspan="5">Relevant parameters as per specific investment mandates and/or specific trust deeds</td><td>term</td><td>yes</td><td colspan="2" rowspan="5">Relevant parameters as per specific investment mandates and/or specific trust deeds</td></tr>
<tr><td>Equities – UK and Overseas</td><td>term</td><td>yes</td></tr>
<tr><td>Fixed Income, Index Linked Bonds, Unit Trusts</td><td>term</td><td>yes</td></tr>
<tr><td>War Stock</td><td>term</td><td>no</td></tr>
<tr><td>Alternative Investments - Property</td><td>term</td><td>yes</td></tr>
</table>

Appendix 5

Permitted Investments – Non Treasury Investments

Definition of non treasury investments

Regulation 9 of the Local Government Investment (Scotland) Regulations 2010 adds to the normal definition of investments the following categories: -

a) All share holding, unit holding and bond holding, including those in a local authority owned company, is an investment;

b) Loans to a local authority company or other entity formed by a local authority to deliver services, is an investment;

c) Loans made to third parties are investments;

d) Investment property is an investment.

However, the following loans are excluded from the definition of investments: -

- Loans made by a local authority to another authority or harbour authority using powers contained in Schedule 3, paragraph 10 or 11 of the Local Government (Scotland) Act 1975.

Permitted Investments – Non-Treasury Investments

The Council approves the following forms of investment instruments for use as permitted investments for Non-Treasury Investments as set out in the Table below:

Investments

	Minimum Credit Criteria	**Liquidity risk**	**Market risk**	**Max % of total investments**	**Max. maturity period**
Loans to Companies, including Local Authority owned.		term	no		
Shares and Bonds in Companies, including Local Authority owned.		term	no		
Loans to Third Parties including investments in sub-ordinated debt (see note 1 and 2).	See Regulation Notes below	instant	no	See Regulation Notes below	
Local Authority Investment Properties.		term	No		
Other Investment Deposits (see note 3)		term	no		

Regulation 24. A local authority shall state the limits for the amounts which, at any time during the financial year, may be invested in each type of permitted investment, such limit being applied when the investment is made. The limits may be defined by reference to a sum of money or a percentage of the local authority's overall investments, or both. A local authority may state that a permitted investment is unlimited. Where a limit is not placed on any type of permitted investment the risk assessment must support that categorisation and an explanation provided as to why an unlimited categorisation is recommended.

Regulation 25. The local authority should identify for each type of permitted investment the objectives of that type of investment. Further, the local authority should identify the treasury risks associated with each type of investment, together with the controls put into place to limit those risks. Treasury risks include credit or security risk of default, liquidity risk – the risks associated with committing funds to longer term investments and market risk – the effect of market prices on investment value.

Regulation 32. The Strategy shall include details of the maximum value and maximum periods for which funds may prudently be invested. The Strategy shall set out the local authority objectives for holding longer term investments. The Strategy shall also refer to the procedures for reviewing the holding of longer term investments particularly those investments held in properties, shareholdings in companies or joint ventures.

The policy above, and requirements of regulations 24, 25 and 32, will be considered, and reported to members, as part of any report pertaining to new investment proposals.

In Part 1, section 12 of the Regulations, Consent includes as an investment any loan issued to a third party. Such loans are neither capital nor revenue transactions, but are often made for Service reasons and for which specific statutory provision exists. For Service reasons these loans may be offered at an interest rate below the market rate. All loans to third parties are classified as investments for the purposes of the Consent. Where the loan is advanced at less than a market interest rate there is an associated loss of investment return which would otherwise have been earned on these monies. The Council's Annual Accounts will recognise and present all loans to third parties as investments.

This Council will refrain from issuing loans to third parties at less than market rate. If, in exceptional circumstances, the Council agrees to issue a loan/s to third parties at less than market rate the associated loss of investment return will be chargeable to the budget of the sponsoring Service. In circumstances where investment risk is a predominant factor the rate chargeable will reflect the equivalent market rate where this is greater than the Council's Loans Fund's most recent actual average interest rate. In all other cases the interest rate chargeable will be the Council's Loans Fund's most recent actual average interest rate.

Note 1 – Subordinated Debt – the Highland Council, on 25 October 2012, agreed to permit an investment, at a maximum level of £1m for all current and future investments, for a maximum maturity period of 25 years, in 'Hub Co' projects.

Note 2 – Landbanking Fund and Loan Advances to Registered Social Landlords (RSLs) – the Council has for many years operated a 'landbank fund'. The fund is used to provide loans and grants to partner organisations (including RSLs), enabling strategic sites to be secured or prepared for development of housing. The Landbank Fund is a revolving facility with loans repaid as land and property is resold or developed.

Note 3 – Local Authority Mortgage Scheme (LAMS) – the Highland Council on 9 May 2013 agreed to participate in the LAMS scheme. This would result in the Council placing £1m on deposit with the mortgage lender (Lloyds), for the lender to use that deposit as guarantee to support the advance of mortages to first time buyers. The mortgage advance would be on terms that required a lower form of deposit from the borrower than ordinarily required, thereby supporting home ownership. The Council would receive a return on its deposit, expected to be at a premium to market rates. The deposit would be at risk in the event of any mortgage default. As at February 2014, the Council has not progressed the LAMS scheme due to the subsequent launch of the UK Help to Buy Scheme. While there are no imminent plans to progress the LAMS scheme at this time, the formal approval for the arrangement remains in place and would allow the Council to progress should circumstances alter.

Permitted Investments – Treasury Management **Appendix 6**

The Council's policy in relation to permitted investments, is a three-stage process as summarised below.

1. Only use of permitted investments per the investment strategy is allowed. See Appendix 7 for definition of the different types of investment.
2. Credit-worthiness of counter-parties will be assessed having taken advice from the Council's treasury management advisers, Capita. Maximum maturity periods for individual counter-parties will be based upon advice from the Adviser, with limits on treasury investments > 364 days as per the prudential indicators, and shown below.
3. Counter-party limits, as set out within the investment strategy will be applied.

The following sections explain each aspect of the 3-stage process in further detail.

<u>Stage 1 - Permitted Investments</u>

The Council approves the following forms of investment instruments for use as permitted treasury management investments as set out in the Tables below. While there is a maximum permitted maturity period set out in the Tables, the actual maturity period will be based on an assessment of risk as part of the credit-worthiness assessment (see stage 2).

In relation to Money Market Funds, only AAA rated Sterling denominated funds will be used.

In relation to all other counter-parties, the Council will only use UK based institutions. For example UK banks and building societies, UK Local Authorities, HM Treasury Debt Management Office.

a. Deposits (UK institutions only)

	Minimum Credit Criteria	**Liquidity risk**	**Market risk**	**Max % of total investments (Stage 2 Below)**	**Max. maturity period**
Debt Management Agency Deposit Facility	--	term	no	**100**	**6 mths**
Term deposits – local authorities	--	term	no	**100**	**2 yrs**
Term deposits – banks and building societies	See Stage 2 below	term	yes	**100**	**2 yrs**
Call accounts – banks and building societies	See Stage 2 below	instant	yes	**100**	**1 yr**

b. Deposits with counterparties currently in receipt of government support/ownership (UK institutions only)

	Minimum Credit Criteria	**Liquidity risk**	**Market risk**	**Max % of total investments (Stage 2 Below)**	**Max. maturity period**
UK nationalised banks	See Stage 2 Below	term	limited	**100**	**2 yrs**

Term deposits – banks and building societies	See Stage 2 below	term	limited	**100**	**2 yrs**
UK Government support to the banking sector (implicit guarantee)	See Stage 2 below	term	limited	**100**	**2 yrs**

c. Collective investment schemes structured as Open Ended Investment Companies (OEICs). Sterling Deposits Only.

	Minimum Credit Criteria	**Liquidity risk**	**Market risk**	**Max % of total investments**	**Max. maturity period**
Money Market Funds	Short Term F1+ Long-term AAA__ Volatility rating MR1+	instant	See Note 1	**100**	**1 yr**

Note 1 – Money Market Funds: These funds invest in short term instruments such as Government/Treasury issues, short-term corporate paper and Certificates of Deposits. By keeping a short time-frame, these funds attempt to reduce risk. 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 – see Appendix 7 Paragraph 3 (a) for more details. Each Money Market Fund is treated as a single counter-party in relation to counter-party limits.

Note 2 - If forward deposits are to be made, the forward period plus the deal period will not exceed one year in aggregate.

Stage 2 – Credit worthiness policy and assessment

This Council uses the creditworthiness service provided by Capita Treasury Services. This service employs a sophisticated modelling approach with credit ratings from all three 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
- 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 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 also used by the Council to determine the duration for investments.

- All credit ratings are monitored from a weekly list which can be updated daily by Capita. The Council is alerted to changes to ratings of all three agencies as these occur through its use of the Capita creditworthiness 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 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 Councils lending list.

Based on the Capita approach, the Council will therefore use counterparties within the following durational bands:

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

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

In relation to Money Market Funds, the Council will use Capita's weekly investment monitor, and other regular updates, to ensure its MMF counter-parties meet the minimum credit criteria described in the table above.

As set out within the Prudential Indicators, a limit is set on the value of Treasury Investments which can be invested for more than 364 days. The limit is £20m, which represents the maximum sum invested for longer than 364 days. Though the period of investment must be decided using Capita credit ratings and maximum limits in permitted investments.

<u>Stage 3 – Counter-party Limits</u>

The limits described below apply to the Council's treasury management operations. Separate limits apply for the Pension Fund, with Highland Council limits relating to all operations excluding the Pension Fund.

Due to market volatility in treasury management investments and varying levels of investment it is possible that at any time in the year one category of investment could represent 100% of the portfolio although it is likely that investments will carry greater diversification than this.

No more than £15m can be invested with any single counterparty, with the exception of the nationalised or semi nationalised UK banks (see section B above) where no more than £25m can be invested in each bank.

The Council will place overnight and call deposits with the Council's bankers irrespective of credit rating. The limit on placing call deposits with the Council's bankers is currently £10m for the Highland Council bank accounts.

The Highland Council Pension Fund will place overnight and call deposits with the Council's bankers irrespective of credit rating. The limit on placing call deposits with the Council's bankers is currently £10m. The Pension Fund may also utilise other bank facilities, with a £10m limit applying to each.

Appendix 7

Current counter party list as at 27/01/2014

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

	At time of investment use Capita rating Current rating 27/01/14	**Maximum Duration per TMSS**	**Investment limits**	
			Highland Council	**Highland Council Pension Fund (note 1)**
Government Backed Deposits				
Debt Management Agency Deposit Facility	Yellow (5 years)	6 months	Unlimited	Not used
Deposits with Counterparties currently in receipt of Government Support/Ownership				
RBS	Blue (1 year)	2 years	£25m	£10m
Bank of Scotland	Blue (1 year)	2 years	£25m	Not used
Term deposits (*restricted to £20m invested >364 days*)				
Term deposits – local authorities	Yellow (5 years)	2 years	£15m	Not used
Term deposits – banks and building societies (UK only)	Varies	2 years	£15m	Not used
Nationwide	Green (100 days)	2 years	£15m	Not used
Call accounts (UK only)				
Clydesdale Bank (Council's Banker)	No colour	1 year	£10m	£10m
Barclays	Green (100 days)	1 year	£15m	Not used
Santander	Green (100 days)	1 year	£15m	Not used
Money Market Funds				
Ignis Asset Management	AAA	1 Year	£15m	Not used
Insight Asset Management	AAA	1 Year	£15m	Not used

Note 1 – the Pension Fund currently uses a limited number of counter-parties as shown above. In line with the limits detailed on appendix 6, additional counter-parties could be considered up to the limits stipulated.

Appendix 8 Treasury Management Practice 1 (TMP1) Credit and Counterparty Risk Management

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

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

Type of Investment	Treasury Risks	Mitigating Controls
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.
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.
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.
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.
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.

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 Director of Finance, and if required new counterparties which meet the criteria will be added to the list.

Appendix 9

Treasury Management Scheme of Delegation and Role of Section 95 Officer

(i) The Council

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

(ii) The Council's Finance Housing and Resources Committee

- approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices;
- approval of the division of responsibilities;
- receiving and reviewing regular monitoring reports and acting on recommendations; including scrutiny/review of annual strategy, annual report and mid-year report;
- approving the selection of external service providers and agreeing terms of appointment.

(iii) Director of Finance

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

The Treasury Management Role of the Section 95 Officer

The S95 (responsible) Officer

- 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.