APPENDIX 1

SCOTTISH BORDERS COUNCIL

TREASURY MANAGEMENT STRATEGY (incorporating the Annual Investment Strategy) 2017/18

Finance
Chief Executive Department
Version 1

CONTENTS

1 Purpose and Scope

1.1 The Council is required to receive and approve, as a minimum, three main reports on treasury activity each year, which incorporate a variety of policies, estimated and actual figures.

a) Treasury Management Strategy 2017/18 (this report).
This report is the most important of the three reports and covers:

- The capital plans of the Council (including prudential indicators);
- The treasury management strategy (how the investments and borrowings are organised), including treasury indicators, and
- An investment strategy (investment options and limits applied).

b) Mid Year Treasury Management Report – This will update members with the progress of the capital position, amending prudential indicators as necessary, and assess whether the actual treasury strategy is adhering to the approved strategy, or whether any policies require revision.

c) Annual Treasury Report - This provides details of a selection of actual prudential and treasury indicators compared to the estimates within the strategy and the performance of actual treasury operations.

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

1.3 The treasury management issues covered by this report are:

Capital Issues
- the capital plans and associated prudential indicators

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

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

1.5 The increased Member consideration of treasury management matters and the need to ensure that officers dealing with treasury management are trained and kept up to date requires a suitable training process for Members and officers. This Council will address this important issue by:

a) Elected Members
- Working with members of the Audit Committee to identify their training needs

- Working with Capita Asset Services to identify appropriate training provision for elected members

b) Officers dealing with treasury management matters will have the option of various levels of training including:

- Treasury courses run by the Council's advisers
- Attendance at CIPFA treasury management training events
- Attendance at the CIPFA Scottish Treasury Management Forum and information exchanged via the Treasury Management Forum network
- On the job training in line with the approved Treasury Management Practices (TMPs).

1.6 Treasury Management Consultants

The Council uses Capita Asset Services as its external treasury management advisors.

The Council recognises that responsibility for treasury management decisions remains with the Council at all times and will ensure that it does not rely solely upon information and advice from its external service providers.

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

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

2 Background

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

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

2.3 The Prudential and Treasury Indicators (summarised in **Annex A**) consider the affordability and impact of capital expenditure decisions, and set out the Council's overall capital framework. These Indicators have been developed in line with both the Prudential and Treasury Codes. The treasury service considers the effective funding of these decisions. Together they form part of the process which ensures the Council meets its balanced budget requirement under the Local Government Finance Act 1992. The Treasury Management Strategy therefore forms an integral part of the Council's overall Financial Strategy covering both its revenue and capital budgets.

2.4 CIPFA defines treasury management as:

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

3 The Capital Prudential Indicators 2016/17 – 2021/22

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

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

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

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

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

The draft revenue budget sets loans charges associated with capital borrowing over the next 5 years at £20.0m per annum.

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

3.1 Capital Expenditure (Prudential Indicator PI-1)

a) This prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this planning cycle. The Capital expenditure forecasts for the next five years are detailed below and include budget figures from the Capital Financial Plan for 2017/18 – 2026/27 as well as projected timing adjustments between years.

Capital Expenditure (PI-1) £m	Estimate					
	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Place	22.9	22.6	15.7	24.4	27.3	19.7
People	24.3	15.2	7.2	8.3	9.4	12.9
Chief Executive	9.4	6.1	8.1	4.5	1.2	1.3
Other & Emergency & Unplanned	2.7	2.3	3.4	2.6	2.3	2.3
Planned Phasing Adjustments	0.0	(4.0)	2.1	1.9	0.0	0.0
Total	**59.3**	**42.2**	**36.5**	**41.7**	**40.2**	**36.1**

3.2 Other Relevant Expenditure

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

Other Relevant Expenditure £m	Estimate					
	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Bridge Homes LLP (Affordable house building programme)	2.3	2.0	2.0	-	-	-

3.3 Capital Financing Assumptions

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

Capital Expenditure £m	Estimate					
	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Capital Expenditure – per plan	59.3	38.8	36.5	41.7	40.2	36.1
Previous year movements	-	3.4	-	-	-	-
Other Relevant Expenditure	2.3	2.0	2.0	-	-	-
Total Expenditure	**61.6**	**44.2**	**38.5**	**41.7**	**40.2**	**36.1**
Financed by:						
Capital receipts	1.3	1.9	2.3	1.8	0.3	-
CFCR	0.3	0.3	0.3	-	-	-
Developer Contributions	0.2	1.4	0.7	0.7	0.1	0.1
Govt. General Capital Grants	11.3	14.5	15.4	15.4	14.0	14.0
Govt. Specific Capital Grants	11.4	3.1	2.1	10.1	15.8	13.0
Other Grants & Contributions	2.7	0.9	3.2	2.0	1.5	-
Replacement Funds	2.5	2.0	2.0	2.4	2.0	2.2
Net financing need for the year	**31.9**	**20.1**	**12.5**	**9.3**	**6.5**	**6.8**

3.4 The Council's Borrowing Need (the Capital Financing Requirement – Prudential Indicator PI-2)

a) The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. Any capital expenditure identified above, which has not immediately been paid for (e.g. via grants), will increase the CFR. The CFR does not increase indefinitely, as prudent annual repayments from revenue need to be made which reflect the useful life of capital assets financed by borrowing. From 1 April 2016, authorities may choose whether to use scheduled debt amortisation, (loans charges), or another suitable method of calculation in order to repay borrowing.

b) The CFR includes any other long term liabilities (e.g. PPP schemes, finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes. The Council had £52.9 of liabilities relating to such schemes within the 2016/17 long term liabilities figure. This increases by £21.3m in 2017/18 relating to funding arrangements for the construction of a new High School in Kelso.

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

Capital Financing Requirement (PI-2) £m	**Actual**	**Estimate**					
	15/16	**16/17**	**17/18**	**18/19**	**19/20**	**20/21**	**21/22**
Total CFR (PI-2) *	**262.5**	**284.0**	**293.1**	**293.6**	**291.2**	**286.0**	**280.8**
Movement in CFR represented by:							
Net financing need for the year (above)		31.9	20.1	12.5	9.3	6.5	6.8
Less scheduled debt amortisation and other financing movements		(10.4)	(11.0)	(12.0)	(11.7)	(11.7)	(12.0)
Movement in CFR		**21.5**	**9.1**	**0.5**	**(2.4)**	**(5.2)**	**(5.2)**

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

The increase between 2016/17 and 2017/18 driven by the shift in the net financing need for the year as detailed in the table in section 3.3 a). The main driver for the increase is an increased Capital Programme with significant additions in 2017/18. Additionally borrowing requirements associated with the re-phasing of projects from 2016/17 into 2017/18 and future years have impacted on the total CFR.

4 Treasury Management Strategy

The capital expenditure plans set out in Section 3 provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the relevant professional Codes, so that sufficient cash is available to meet this service activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. The strategy covers the relevant treasury/prudential indicators, the current and projected debt positions and the annual investment strategy.

4.1 Current Portfolio Position

a) The Council's treasury portfolio position at 31 March 2016, with forward projections, is summarised below. The table shows the actual external debt, (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

as at 31 March £m	Estimate				
	2016/17	2017/18	2018/19	2019/20	2020/21
Borrowing	187.6	192.4	198.7	202.3	202.3
Other Long Term Liabilities	52.9	72.9	70.7	68.4	65.9
Total Gross Borrowing (Prudential Indicator PI-5)	**240.5**	**265.4**	**269.4**	**270.7**	**268.2**
CFR – the borrowing need *	**293.6**	**291.2**	**286.0**	**280.8**	**282.2**
(Under) / Over Borrowing (Prudential Indicator PI-6)	**(53.1)**	**(25.8)**	**(16.6)**	**(10.1)**	**(14.0)**

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

b) Within the prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well-defined limits. One of these (PI-6) is that the Council needs to ensure that its gross debt figure (shown above) does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2016/17 and following two financial years. This allows some flexibility for limited borrowing for future years, but ensures that borrowing in advance of need is not undertaken for revenue purposes.

c) The Council has complied with this prudential indicator in the current year and no difficulties are currently envisaged for the long term future. This view takes into account current commitments, existing plans, and the proposals in the Financial Plans for 2017/18.

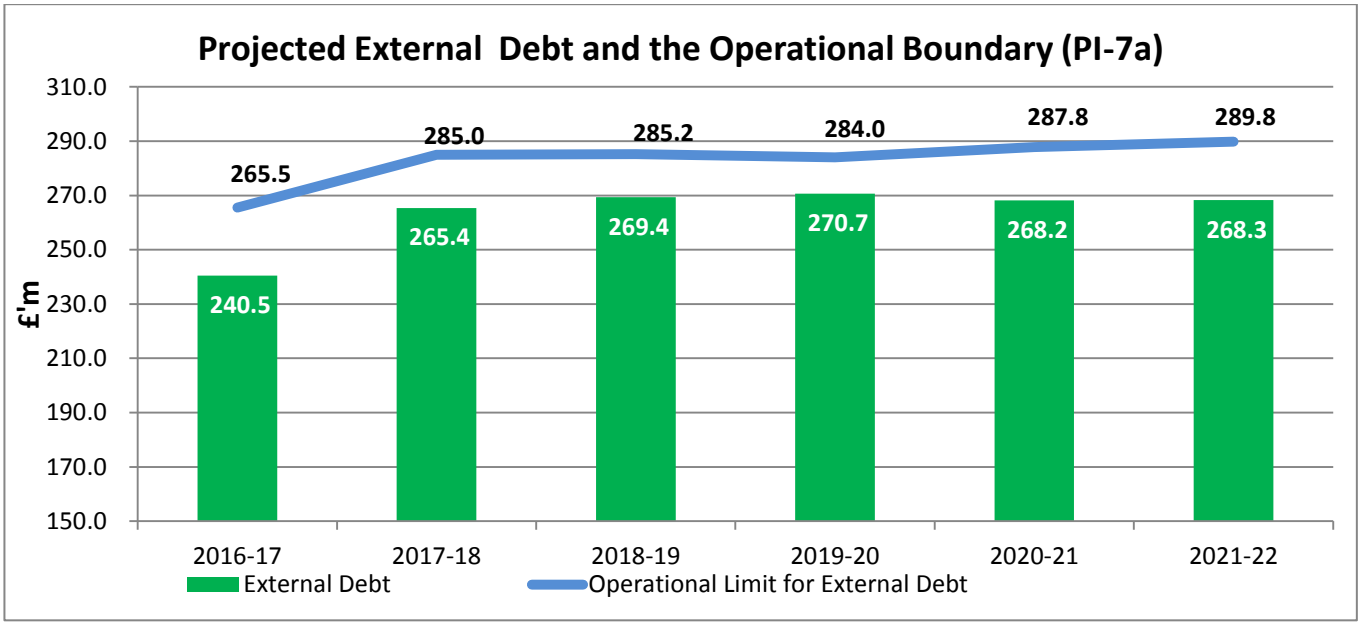
4.2 Treasury Indicators: Limits to Borrowing Activity

The Operational Boundary (Prudential Indicator PI-7)

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

Operational boundary £m	Estimate					
	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Total Operational Boundary (PI-7a)	**265.5**	**285.0**	**285.2**	**284.0**	**287.8**	**289.8**
Less: Other long term liabilities	(52.9)	(72.9)	(70.7)	(68.4)	(65.9)	(63.4)
Operational Boundary exc. Other Long Term Liabilities (PI-7b)	**212.6**	**212.1**	**214.5**	**215.6**	**221.9**	**226.4**

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



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

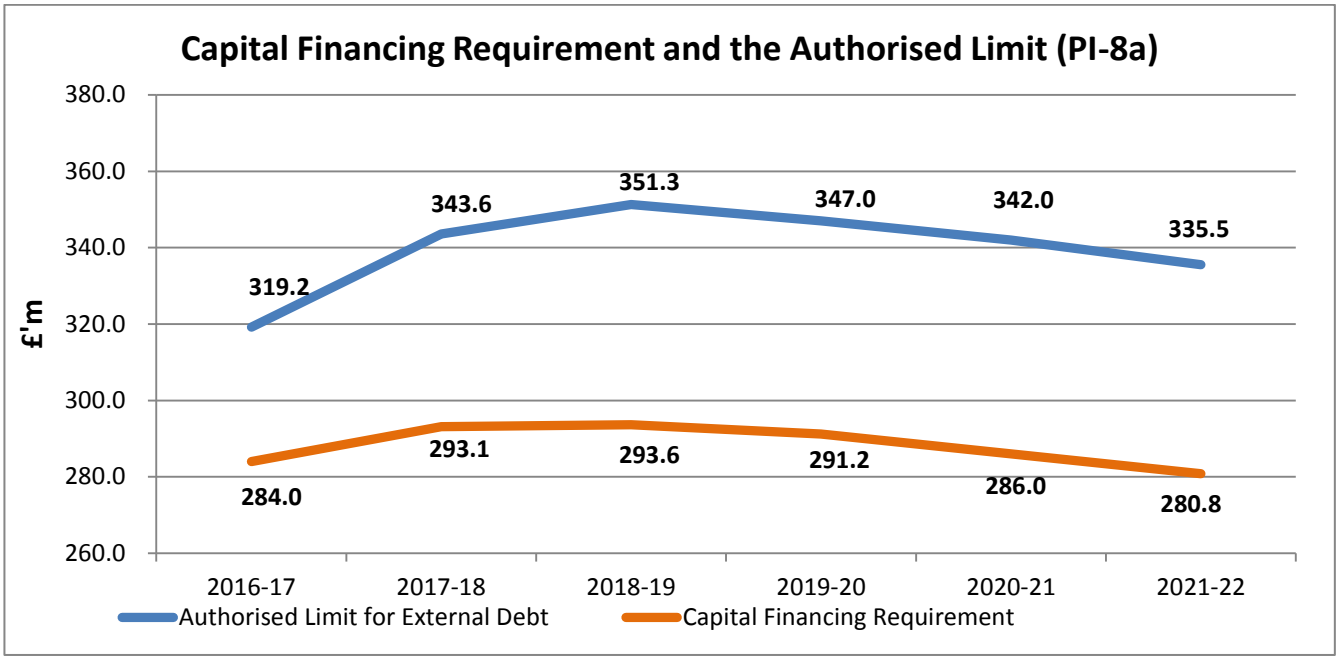
c) A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external borrowing which, while not desired, could be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

d) This is the statutory limit (Affordable Capital Expenditure Limit) determined under section 35(1) of the Local Government in Scotland Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised.

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

Authorised Limit £m	Estimate					
	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Total Authorised Limit (PI-8a)	**319.2**	**343.6**	**351.3**	**347.0**	**342.0**	**335.5**
Less: Other long term liabilities	(52.9)	(72.9)	(70.7)	(68.4)	(65.9)	(63.4)
Authorised Limit exc. Other Long-Term Liabilities (PI-8b)	**266.3**	**270.7**	**280.6**	**278.6**	**276.1**	**272.1**

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



4.3 Prospects for Interest Rates

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

	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Bank rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.60%	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.90%	2.90%	2.90%	2.90%	3.00%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%
50yr PWLB rate	2.70%	2.70%	2.70%	2.70%	2.80%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%

b) The Monetary Policy Committee, (MPC), cut Bank Rate from 0.50% to 0.25% on 4th August in order to counteract what it forecast was going to be a sharp slowdown in growth in the second half of 2016. It also gave a strong steer that it was likely to cut Bank Rate again by the end of the year. However, economic data since August has indicated much stronger growth in the second half 2016 than that forecast; also, inflation forecasts have risen substantially as a result of a continuation of the sharp fall in the value of sterling since early August. Consequently, Bank Rate was not cut again in November and, on current trends, it now appears unlikely that there will be another cut, although that cannot be completely ruled out if there was a significant dip downwards in economic growth. During the two-year period 2017 – 2019, when the UK is negotiating the terms for withdrawal from the EU, it is likely that the MPC will do nothing to dampen growth prospects, (i.e. by raising Bank Rate), which will already be adversely impacted by the uncertainties of what form Brexit will eventually take. Accordingly, a first increase to 0.50% is not tentatively pencilled in, as in the table above, until quarter 2 2019, after those negotiations have been concluded, (though the period for negotiations could be extended). However, if strong domestically generated inflation, (e.g. from wage increases within the UK), were to emerge, then the pace and timing of increases in Bank Rate could be brought forward.

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

d) The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. It has long been expected that at some point, there would be a start to a switch back from bonds to equities after a historic long term trend over about the last twenty five years of falling bond yields. The action of central banks since the financial crash of 2008, in implementing substantial quantitative easing purchases of bonds, added further impetus to this downward trend in bond yields and rising prices of bonds. The opposite side of this coin has been a rise in equity values as investors searched for higher returns and took on riskier assets. The sharp rise in bond yields since the US Presidential election, has called into question whether, or when, this trend has, or may, reverse, especially when America is likely to lead the way in reversing monetary policy. Until 2015, monetary policy was focused on providing stimulus to economic growth but has since started to refocus on countering the threat of rising inflationary pressures as strong economic growth becomes more firmly established. The expected substantial rise in the Fed. rate over the next few years may make holding US bonds much less attractive and cause their prices to fall, and therefore bond yields to rise. Rising bond yields in the US would be likely to exert some upward pressure on bond yields in other developed countries but the degree of that upward

pressure is likely to be dampened by how strong, or weak, the prospects for economic growth and rising inflation are in each country, and on the degree of progress in the reversal of monetary policy away from quantitative easing and other credit stimulus measures.

e) PWLB rates and gilt yields have been experiencing exceptional levels of volatility that have been highly correlated to geo-political, sovereign debt crisis and emerging market developments. It is likely that these exceptional levels of volatility could continue to occur for the foreseeable future.

f) The overall balance of risks to economic recovery in the UK is to the downside, particularly in view of the current uncertainty over the final terms of Brexit and the timetable for its implementation.

g) Apart from the above uncertainties, **downside risks to current forecasts** for UK gilt yields and PWLB rates currently include:

- Monetary policy action by the central banks of major economies reaching its limit of effectiveness and failing to stimulate significant sustainable growth, combat the threat of deflation and reduce high levels of debt in some countries, combined with a lack of adequate action from national governments to promote growth through structural reforms, fiscal policy and investment expenditure.
- Major national polls:
    - Italian constitutional referendum 4.12.16;
    - Spain has a minority with only 137 seats out of 350 after already having had two inconclusive general elections in 2015 and 2016. This is potentially highly unstable.
    - Dutch general election 15.3.17;
    - French presidential election April/May 2017;
    - French National Assembly election June 2017;
    - German Federal election August – October 2017.
- A resurgence of the Eurozone sovereign debt crisis, with Greece being a particular problem, and stress arising from disagreement between EU countries on free movement of people and how to handle a huge influx of immigrants and terrorist threats.
- Weak capitalisation of some European banks, especially Italian.
- Geopolitical risks in Europe, the Middle East and Asia, causing a significant increase in safe haven flows.
- UK economic growth and increases in inflation are weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU and US.

h) The potential for **upside risks to current forecasts** for UK gilt yields and PWLB rates, especially for longer term PWLB rates, include:

- UK inflation rising to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium in gilt yields.
- A rise in US Treasury yields as a result of Fed. funds rate increases and rising inflation expectations in the USA, dragging UK gilt yields upwards.

- The pace and timing of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
- A downward revision to the UK's sovereign credit rating undermining investor confidence in holding sovereign debt (gilts).

i) Investment returns are likely to remain relatively low during 2017/18 and beyond;

- Borrowing interest rates have been on a generally downward trend during most of 2016 up to mid-August; they fell sharply to historically phenomenally low levels after the referendum and then even further after the MPC meeting of 4th August when a new package of quantitative easing purchasing of gilts was announced. Gilt yields have since risen sharply due to a rise in concerns around a 'hard Brexit', the fall in the value of sterling, and an increase in inflation expectations. The policy of avoiding new borrowing by running down spare cash balances, has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in later times when authorities will not be able to avoid new borrowing to finance capital expenditure and/or to refinance maturing debt.
- There will remain a cost of carry to any new long-term borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost. Cost of carry being the difference between borrowing costs and investment returns.

j) **Annex C** contains a more comprehensive Economic Background narrative from Capita Asset Services.

4.4 Borrowing Strategy

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

b) Against this background and the risks within the economic forecast, caution will be adopted with the 2017/18 treasury operations. The Chief Financial Officer will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

- If it was felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast, perhaps arising from an acceleration in the start date and in the rate of increase in central rates in the USA and UK, an increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates are lower than they are projected to be in the next few years.

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

4.5 Policy on borrowing in advance of need

a) Borrowing in advance is defined as any borrowing undertaken by the local authority which will result in the total external debt of the local authority exceeding the capital financing requirement (CFR) of the local authority for the following twelve month period. This twelve month period is on a rolling twelve month basis.

b) The Council will not borrow more than or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed.

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

d) The Chief Financial Officer has the authority to borrow in advance of need under delegated power where, for instance, a sharp rise in interest rates is expected, and so borrowing early at fixed interest rates will be economically beneficial or meet budgetary constraints. The Chief Financial Officer will adopt a cautious approach to any such borrowing and a business case to support the decision making process must consider:

- the benefits of borrowing in advance,
- the risks created by additional levels of borrowing and investment, and
- how far in advance it is reasonable to borrow considering the risks identified

e) Any such advance borrowing should be reported through the mid-year or annual Treasury Management reporting mechanism.

4.6 Debt Rescheduling

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

b) The reasons for any rescheduling to take place will include:

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

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

d) All rescheduling will be reported to the **Executive** at the earliest meeting following its action.

4.7 Treasury Management Earmarked Balance

a) The Council identified, in conjunction with its advisors, that the increasing expectation of interest rate increases in the medium term exposed the Council to financing risk and that it was appropriate to identify approaches to manage this risk.

b) The Council approved the establishment of a Treasury Management Earmarked Balance (the Balance) within the General Fund Reserve for the purposes of managing its costs of treasury and financing activities and the associated financing risk.

c) The Balance creates an appropriate tactical mechanism to make financial provision in the current low interest rate environment to support the Council as interest rates increase and the financing need crystallises. This Balance will provide resource to smooth out potentially higher costs in the future, by having resources which can be used to mitigate costs i n the Council's revenue budget. [the wording of the report on the earmarked balance is quite specific it is carefully worded to ensure this balance can be used flexibly if needs be to support the "finances of the council- it is not therefore just about interest rates although this is the primary purpose

d) The Balance will be funded through the identification of opportunities to earmark funds due to short term savings on the Loans Charges revenue budget resulting from the current prudent approach to capital financing.

5 Investment Strategy

5.1 Investment Objectives and Policy

a) The Council's investment policy has regard to the Scottish Government's Investment (Scotland) Regulations (and accompanying Finance Circular) and the 2011 revised CIPFA Treasury Management in the Public Services Code of Practice and Cross Sectorial Guidance Notes ("the CIPFA TM Code").

b) The Council's primary investment objectives are as follows, in order of importance:

(i) The safeguarding or **security** of the re-payment of principal and interest of investments on a timely basis; and
(ii) The **liquidity** of its investments
(iii) The **returns on investments** that can be realised

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

c) In accordance with the above guidance from the Scottish Government and CIPFA, and in order to minimise the risk to investments, the Council applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the Short and Long term ratings. The intention of the approach is to provide security of investment and minimisation of risk.

d) The borrowing of monies purely to invest or on-lend, without relevant Scottish Government consent, is unlawful and this Council will not engage in such activity.

e) The Council will ensure its investments have sufficient liquidity. For this purpose it will set out procedures for determining the maximum periods over which funds may prudently be committed.

5.2 Council Permitted Investments

a) The Local Government Investments (Scotland) Regulations 2010 require the Council to give approval for 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 have not been approved as a permitted investment will be considered ultra vires.

b) The permitted investment instruments which may be used by the Council (and its subsidiary organisations) in the forthcoming year are detailed in **Annex D**, and include the following:

Cash type instruments

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

Other investments

- Investment properties
- Loans to third parties, including soft loans
- National Housing Trust (NHT)
- Investments in and loans to local authority companies/partnerships
- Pooled Investment Vehicles
- Investment in the subordinated debt of projects delivered via the 'HubCo' model

c) Details of the risks, mitigating controls and limits associated with each of these permitted categories are shown in **Annex D.**

d) Common Good and Pension Fund permitted investments are also shown at **Annex D** and, where applicable, the same counterparty selection criteria as for the Council will be applied foe SBCares

e) The Treasury Management Strategy only applies to the funds managed in-house for the Pension Fund, as the externally invested funds are covered by the Pension Fund's Statement of Investment Principles and other associated policy documents.

5.3 Creditworthiness Policy

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

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

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

Creditworthiness Colour Banding	Maximum Investment Duration
Yellow	5 years
Dark pink	5 years for Enhanced Money Market Funds (EMMFs) with a credit score of 1.25
Light pink	5 years EMMFs with a credit score of 1.5
Purple	2 years
Blue	1 year (only applies to nationalised or semi-nationalised UK Banks)
Orange	1 year
Red	6 months
Green	100 days
No colour	not to be used (ie don't invest)

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

d) The creditworthiness service provided by Capita 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.

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

f) All credit ratings will be monitored on a real time basis. The Council is alerted to changes to ratings of all three agencies through its use of our creditworthiness service.

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

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

5.4 Country and Sector Considerations

a) Due care will be taken to consider the country and sector exposure of the Council's investments.

Country Limits

b) If the institution is non-UK, then the country in which it is domiciled must have a minimum Sovereign long term rating of AAA. (USA currently AA+).

c) No more than **10%** will be placed with any non-UK country at any time.

Institutional Sector Limits

d) These institutions must either be UK Local Authorities or UK Incorporated Institutions, UK Banks and Building Societies incorporated in the European Economic Area entitled to accept deposits through a branch in the UK. The Council may also use the UK Government including in the form of gilts and the Debt Management Account Deposit Facility (DMADF).

e) Limits will be applied to the overall amount lent out to any one sector at any one time in order to limit sector specific exposure risk, as follows:

UK Building Societies	**£25 m**
Banks	**£35 m**
UK Local Authorities	**£40 m**
UK Government Debt Management Office	**£unlimited**
UK Gilts and Treasury Bills	**£20 m**
Institutions covered by Government Guarantee	**£10 m**
Part Nationalised Banks	**£35 m**
Money Market Funds (AAA)	**£20 m**

These limits will be monitored regularly for appropriateness.

Group Limits

g) Limits will be applied to the overall amount lent out to institutions within the same group at any one time in order to limit group specific exposure risk, as follows, and subject to the parent company appearing on Capita Asset Services' creditworthiness list:

Group of Banks	**£10m**

Council's Own Banker

h) The Council's own banker (Bank of Scotland – part of Lloyds) will be maintained on the Council's counterparty list in situations where rating changes may mean this is below the above criteria. This is to allow the Council to continue to operate normal current account banking facilities and overnight and short-term investment facilities. However, in the event that the rating does change below the criteria, officers will review the situation carefully and identify any appropriate action required to manage the risk that this change creates for the Council.

5.5 Individual Institution Monetary Limits

a) The monetary limits for institutions on the Council's Counterparty List are as follows:

	Money Limit
UK Building Societies	£5m
Banks	£5m
UK Local Authorities (i)	£40m
UK Government Debt Management Office	Unlimited
UK Gilts & Treasury Bills	£20m
Government Guaranteed Institutions	£2m
AAA rated Money Market Funds	£5m
Council's Own Banker (ii)	£5m

(i) No individual limit will be applied on lending to a UK local authority, other than it must not exceed the relevant sector limit of £40m.

(ii) Further to Sections 5.4 and 5.5, in the event that the rating of the Council's own banker falls below the criteria, the time limit on money deposited with the bank will be reduced to an overnight basis.

b) As mentioned earlier, the treasury function manages the funds of the Council, any subsidiary organisations, the Pension Fund and the Common Good and Trust Funds. When applying the limits set out in the table above, these limits will apply to the cumulative investment with an institution from the Council, the Pension Fund and the Common Good Funds and Trust Funds.

5.6 Types of Investments

a) For institutions on the approved counterparty list, investments will be restricted to safer instruments (such as deposits). Currently this involves the use of money market funds, the DMADF and institutions with higher credit ratings than the minimum permissible rating outlined in the investment strategy, as well as the Council's own bank.

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

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

5.7 Investment Strategy and bank rate projections

In-house funds

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

Investment returns expectations

b) Bank Rate is forecast to stay flat at 0.25% until quarter 2, 2019 and not to rise above 0.75% by quarter 1, 2020. Bank rate forecasts for financial year-ends (March) are:

2016/2017	0.25%
2017/2018	0.25%
2018/2019	0.25%
2019/2020	0.50%

c) The overall balance of risks to these forecasts is currently probably slightly skewed to the downside in view of the uncertainty over the final terms of Brexit. If growth expectations disappoint and inflationary pressures are minimal, the start of increases in Bank Rate could be pushed back. On the other hand, should the pace of growth quicken and / or forecasts for increases in inflation rise, there could be an upside risk i.e. Bank Rate increases occur earlier and / or at a quicker pace.

Investment Treasury Indicator and Limit (Treasury Indicator TI-5)
Total Principal Funds Invested for greater than 364 days

d) These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

The treasury indicator and limit proposed is:

Maximum principal sums invested > 364 days (TI-5)					
£m	**2016/17**	**2017/18**	**2018/19**	**2019/20**	**2020/21**
Principal sums invested > 364 days	20%	20%	20%	20%	20%

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

5.8 Investment Risk Benchmarking

These benchmarks are simple guides to maximum risk, so they may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmarks are that officers will monitor the current and trend position and amend the operational strategy to manage risk as conditions change. Any breach of the benchmarks will be reported, with supporting reasons in the mid-year or annual report.

a) Security

The Council's **maximum** security risk benchmark for the current portfolio, when compared to historic default tables, is:

0.04% historic risk of default when compared to the whole portfolio.

b) Liquidity

In respect of this area the Council seeks to maintain:

- Bank Overdraft: £250,000
- Liquid short term deposits of at least £3,000,000 available with a week's notice.

- Weighted Average Life (WAL) benchmark is **expected to be 0.5 years** (equivalent to a weighted average life of 6 months), with a **maximum of 1.0 year.** WAL represents the average length of time that each £ of principal investment remains invested.

c) Yield

Local measures of yield benchmarks are:

Investments – **Internal returns above the 7 day LIBID rate**

d) At the end of the financial year, the Chief Financial Officer will report on its investment activity as part of the annual treasury report.

6 Performance Indicators

6.1 The CIPFA Code requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking.

6.2 Debt Performance Indicators

(i) Average "Pool Rate" charged by the Loans Fund compared to Scottish Local Authority average Pool Rate.

Target is to be at or below the Scottish Average for 2016/17.

(ii) Average borrowing rate movement year on year

Target is to maintain or reduce the average borrowing rate for the Council versus 2015/16.

6.3 **Investment Risk Benchmark Indicators** for Security, Liquidity and Yield, as set out in paragraph 5.9.

6.4 Loan Charges

a) Loan Charges for 2017/18 are expected to be at or below the Revenue Budget estimate contained in the Council's Financial Plans to be approved in February 2017, which are estimated as follows:

£m	2017/18	2018/19	2019/20	2020/21	2021/22
Interest on Borrowing	11.0	10.5	10.7	11.0	10.6
Investment income	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)
Capital Repayments	9.1	9.6	9.4	9.1	9.5
Total Loan Charges *	**20.0**	**20.0**	**20.0**	**20.0**	**20.0**

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

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

6.5 The indicators, based on actual performance for the year, will be included in the Treasury Management Annual Report for 2017/18.

7 Monitoring and Reporting

7.1 In line with the CIPFA Code the following formal reporting arrangements will be adopted:

Requirement	Purpose	Decision making body	Frequency
Treasury Management Policy Statement	Reviews and Revisions	Executive	As required
Treasury Management & Investment Strategy	Reporting of Annual Strategy	Council	Annually prior to start of new financial year
Treasury Management Strategy and / or Treasury Investment Strategy	Updates and revisions	Council	As appropriate
Treasury Management Mid-Year Report	Mid-Year Performance Report	Council	Annually in October/November of the current year
Treasury Management Annual Report	Annual Performance report for previous financial year	Council	Annually following the revenue outturn report to Executive
Treasury Management Monitoring Reports	Including Revenue Budget Monitoring	Executive	Revenue reported as part of the regular monitoring reports, otherwise as and when appropriate
Treasury Management Practices		Executive	As appropriate
Scrutiny of Treasury Management & Investment Strategy	Detailed scrutiny prior to annual approval by Council	Audit & Risk Committee	Annually
Scrutiny of Treasury Management Performance		Audit & Risk Committee	As appropriate

ANNEXES

ANNEX A
SUMMARY OF PRUDENTIAL AND TREASURY INDICATORS

Indicator Ref.	Indicator	Page Ref.	2017/18	2018/19	2019/20	2020/21	2021/22
PRUDENTIAL INDICATORS							
Capital Expenditure Indicator							
PI-1	Capital Expenditure Limits (£m)	5	42.2	36.5	41.7	40.2	36.1
PI-2	Capital Financing Requirement (CFR) (£m)	7	293.1	293.6	291.2	286.0	280.8
External Debt Indicators							
PI-5	Actual Debt (£m)	8	265.4	269.4	270.7	268.2	268.3
PI-7a	Operational Boundary (inc. Other Long Term Liabilities) (£m)	9	285.0	285.2	284.0	287.8	289.8
PI-7b	Operational Boundary (exc. Other Long Term Liabilities) (£m)	9	212.1	214.5	215.6	221.9	226.4
PI-8a	Authorised Limit (inc. Other Long Term Liabilities) (£m)	10	343.6	351.3	347.0	342.0	335.5
PI-8b	Authorised Limit (exc. Other Long Term Liabilities) (£m)	10	270.6	280.6	278.6	276.1	272.1
Indicators of Prudence							
PI-6	(Under)/Over Gross Borrowing against the CFR (£m)	9	(25.8)	(16.6)	(10.1)	(14.0)	(10.6)
TREASURY INDICATORS							
TI-1	Upper Limit to Fixed Interest Rates based on Net Debt (£m)	14	285.0	285.2	284.0	287.8	289.8
TI-2	Upper Limit to Variable Interest Rates based on Net Debt (£m)	14	99.8	99.8	99.4	100.7	101.4
TI-3	Maturity Structure of Fixed Interest Rate Borrowing 2012/13	14	**Lower**		**Upper**		
	Under 12 months		0%		20%		
	12 months to 2 years		0%		20%		
	2 years to 5 years		0%		20%		
	5 years to 10 years		0%		20%		
	10 years and above		20%		100%		
TI-4	Maximum Principal Sum invested greater than 364 days	21	20%	20%	20%	20%	20%
Affordability Indicator							
PI-3	Ratio of Financing Costs to Net Revenue (inc. PPP repayment costs)	26	9.1%	9.6%	9.7%	9.4%	9.5%
PI-4	Incremental (Saving)/Cost Impact of Capital Investment Decisions on Council Tax	26	(£0.02)	(£0.01)	(£0.01)	(£0.01)	(£0.01)

Further prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. The updated indicators are as follows:

Ratio of financing costs to net revenue stream (Prudential Indicator PI-3)

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

%	Actual	Estimate				
	15/16	16/17	17/18	18/19	19/20	20/21
Ratio of Financing Costs to Net Revenue Stream (PI-3) *(inc. PPP repayment costs)*	8.8	8.5	9.1	9.6	9.7	9.4

The estimates of financing costs include current commitments and the proposals in the Financial Plans for 2016/17. The movements in the above ratio from 2017/18 onwards reflect a reduction in overall financial resources available to the Council.

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

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

£	Estimate				
	2017/18	2018/19	2019/20	2020/21	2021/22
Incremental (Saving)/Cost Impact of Capital Investment Decisions on the Band D Council Tax (PI-4)	(0.02)	(0.01)	(0.01)	(0.01)	(0.01)

Treasury Management Limits on Activity

There are three debt related treasury activity limits. The purpose of these are to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates. However, if these are set to be too restrictive, they will impair the opportunities to reduce costs / improve performance. The indicators are:

(i) Upper limits on fixed interest rate exposure (Treasury Indicator TI-1)

This identifies a maximum limit for borrowing exposure to fixed interest rates, based on the debt position net of investments.

(ii) Upper limits on variable interest rate exposure (Treasury Indicator TI-2)

This identifies a maximum limit for borrowing exposure to variable interest rates based upon the debt position net of investments.

(iii) Maturity structure of borrowing (Treasury Indicator TI-3)

These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

(iv) The following table highlights the proposed treasury indicators and limits:

£m	2016/17	2017/18	2018/19	2019/20	2020/21
Interest rate exposures					
	Upper	**Upper**	**Upper**	**Upper**	**Upper**
Limits on fixed interest rates based on net debt (TI-1)	265.5	285.0	285.2	284.0	287.8
Limits on variable interest rates based on net debt (TI-2)	92.9	99.8	99.8	99.4	100.7
Maturity Structure of fixed interest rate borrowing 2015/16 (TI-3)					
		Lower		**Upper**	
Under 12 months		0%		20%	
12 months to 2 years		0%		20%	
2 years to 5 years		0%		20%	
5 years to 10 years		0%		20%	
10 years and above		20%		100%	

ANNEX B: INTEREST RATE FORECASTS 2017-20

Capita Asset Services Interest Rate View													
	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Dec-19	Mar-20
Bank Rate View	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.75%	0.75%
3 Month LIBID	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.40%	0.50%	0.60%	0.80%	0.90%
6 Month LIBID	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.50%	0.60%	0.70%	0.90%	1.00%
12 Month LIBID	0.70%	0.70%	0.70%	0.70%	0.70%	0.70%	0.80%	0.80%	0.90%	1.00%	1.10%	1.30%	1.40%
5yr PWLB Rate	1.60%	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.80%	1.80%	1.90%	2.00%	2.00%
10yr PWLB Rate	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%	2.60%	2.70%
25yr PWLB Rate	2.90%	2.90%	2.90%	2.90%	3.00%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%
50yr PWLB Rate	2.70%	2.70%	2.70%	2.70%	2.80%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.20%
Bank Rate													
Capita Asset Services	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.75%	0.75%
Capital Economics	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.75%
5yr PWLB Rate													
Capita Asset Services	1.60%	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.80%	1.80%	1.90%	2.00%	2.00%
Capital Economics	1.60%	1.70%	1.80%	1.90%	1.95%	2.05%	2.20%	2.30%	2.40%	2.60%	2.80%	3.20%	3.30%
10yr PWLB Rate													
Capita Asset Services	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%	2.60%	2.70%
Capital Economics	2.30%	2.35%	2.45%	2.50%	2.55%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%	3.60%	3.70%
25yr PWLB Rate													
Capita Asset Services	2.90%	2.90%	2.90%	2.90%	3.00%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%
Capital Economics	2.90%	3.00%	3.05%	3.10%	3.15%	3.25%	3.30%	3.35%	3.45%	3.55%	3.75%	4.15%	4.35%
50yr PWLB Rate													
Capita Asset Services	2.70%	2.70%	2.70%	2.70%	2.80%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.20%
Capital Economics	2.80%	2.85%	2.95%	3.00%	3.05%	3.10%	3.15%	3.20%	3.30%	3.50%	3.70%	4.10%	4.20%

Please note – The current PWLB rates and forecasts shown above have taken into account the 20 basis point certainty rate reduction effective as of the 1st November 2012.

Source: Capita Asset Services, December 2016

ANNEX C
Economic Background

UK. GDP growth rates in 2013, 2014 and 2015 of 2.2%, 2.9% and 1.8% were some of the strongest rates among the G7 countries. Growth is expected to have strengthened in 2016 with the first three quarters coming in respectively at +0.4%, +0.7% and +0.5%. The latest Bank of England forecast for growth in 2016 as a whole is +2.2%. The figure for quarter 3 was a pleasant surprise which confounded the downbeat forecast by the Bank of England in August of only +0.1%, (subsequently revised up in September, but only to +0.2%). During most of 2015 and the first half of 2016, the economy had faced headwinds for exporters from the appreciation of sterling against the Euro, and weak growth in the EU, China and emerging markets, and from the dampening effect of the Government's continuing austerity programme.

The **referendum vote for Brexit** in June 2016 delivered an immediate shock fall in confidence indicators and business surveys at the beginning of August, which were interpreted by the Bank of England in its August Inflation Report as pointing to an impending sharp slowdown in the economy. However, the following monthly surveys in September showed an equally sharp recovery in confidence and business surveys so that it is generally expected that the economy will post reasonably strong growth numbers through the second half of 2016 and also in 2017, albeit at a slower pace than in the first half of 2016.

The **Monetary Policy Committee, (MPC), meeting of 4th August** was therefore dominated by countering this expected sharp slowdown and resulted in a package of measures that included a cut in Bank Rate from 0.50% to 0.25%, a renewal of quantitative easing, with £70bn made available for purchases of gilts and corporate bonds, and a £100bn tranche of cheap borrowing being made available for banks to use to lend to businesses and individuals.

The **MPC meeting of 3 November** left Bank Rate unchanged at 0.25% and other monetary policy measures also remained unchanged. This was in line with market expectations, but a major change from the previous quarterly Inflation Report MPC meeting of 4 August, which had given a strong steer, in its forward guidance, that it was likely to cut Bank Rate again, probably by the end of the year if economic data turned out as forecast by the Bank.

The latest MPC decision included a forward view that **Bank Rate** could go either up or down depending on how economic data evolves in the coming months. Our central view remains that Bank Rate will remain unchanged at 0.25% until the first increase to 0.50% in quarter 2 2019 (unchanged from our previous forecast). However, we would not, as yet, discount the risk of a cut in Bank Rate if economic growth were to take a significant dip downwards, though we think this is unlikely. We would also point out that forecasting as far ahead as mid 2019 is highly fraught as there are many potential economic headwinds which could blow the UK economy one way or the other as well as political developments in the UK, (especially over the terms of Brexit), EU, US and beyond, which could have a major impact on our forecasts.

The pace of Bank Rate increases in our forecasts has been slightly increased beyond the three year time horizon to reflect higher inflation expectations.

The August quarterly Inflation Report was based on a pessimistic forecast of near to zero GDP growth in quarter 3 i.e. a sharp slowdown in growth from +0.7% in quarter 2, in reaction to the shock of the result of the referendum in June. However, **consumers** have very much stayed in a 'business as usual' mode and there has been no sharp downturn in spending; it is consumer expenditure that underpins the services sector which comprises about 75% of UK GDP. After a fairly flat three months leading up to October, retail sales in October surged at the strongest rate since September 2015. In addition, the GfK consumer confidence index has recovered quite strongly to -3 in October after an initial sharp plunge in July to -12 in reaction to the referendum result.

Bank of England GDP forecasts in the November quarterly Inflation Report were as follows, (August forecasts in brackets) - 2016 +2.2%, (+2.0%); 2017 1.4%, (+0.8%); 2018 +1.5%, (+1.8%). There has, therefore, been a sharp increase in the forecast for 2017, a marginal increase in 2016 and a small decline in growth, now being delayed until 2018, as a result of the impact of Brexit.

Capital Economics' GDP forecasts are as follows: 2016 +2.0%; 2017 +1.5%; 2018 +2.5%. They feel that pessimism is still being overdone by the Bank and Brexit will not have as big an effect as initially feared by some commentators.

The Chancellor has said he will do 'whatever is needed' i.e. to **promote growth**; there are two main options he can follow – fiscal policy e.g. cut taxes, increase investment allowances for businesses, and/or increase government expenditure on infrastructure, housing etc. This will mean that the PSBR deficit elimination timetable will need to slip further into the future as promoting growth, (and ultimately boosting tax revenues in the longer term), will be a more urgent priority. The Governor of the Bank of England, Mark Carney, had warned that a vote for Brexit would be likely to cause a slowing in growth, particularly from a reduction in business investment, due to the uncertainty of whether the UK would have continuing full access, (i.e. without tariffs), to the EU single market. He also warned that the Bank could not do all the heavy lifting to boost economic growth and suggested that the Government would need to help growth e.g. by increasing investment expenditure and by using fiscal policy tools. The newly appointed Chancellor, Phillip Hammond, announced, in the aftermath of the referendum result and the formation of a new Conservative cabinet, that the target of achieving a budget surplus in 2020 would be eased in the Autumn Statement on 23 November.

The other key factor in forecasts for Bank Rate is **inflation** where the MPC aims for a target for CPI of 2.0%. The November Inflation Report included an increase in the peak forecast for inflation from 2.3% to 2.7% during 2017; (Capital Economics are forecasting a peak of 3.2% in 2018). This increase was largely due to the effect of the sharp fall in the value of sterling since the referendum, (16% down against the US dollar and 11% down against the Euro); this will feed through into a sharp increase in the cost of imports and materials used in production in the UK. However, the MPC is expected to look through the acceleration in inflation caused by external, (outside of the UK), influences, although it has given a clear warning that if wage inflation were to rise significantly as a result of these cost pressures on consumers, then they would take action to raise Bank Rate.

What is clear is that **consumer disposable income** will come under pressure, as the latest employers' survey is forecasting median pay rises for the year ahead of only 1.1% at a time when inflation will be rising significantly higher than this. The CPI figure for October surprised by under shooting forecasts at 0.9%. However, producer output prices rose at 2.1% and core inflation was up at 1.4%, confirming the likely future upwards path.

Gilt yields, and consequently PWLB rates, have risen sharply since hitting a low point in mid-August. There has also been huge volatility during 2016 as a whole. The year started with 10 year gilt yields at 1.88%, fell to a low point of 0.53% on 12 August, and have hit a peak on the way up again of 1.46% on 14 November. The rebound since August reflects the initial combination of the yield-depressing effect of the MPC's new round of quantitative easing on 4 August, together with expectations of a sharp downturn in expectations for growth and inflation as per the pessimistic Bank of England Inflation Report forecast, followed by a sharp rise in growth expectations since August when subsequent business surveys, and GDP growth in quarter 3 at +0.5% q/q, confounded the pessimism. Inflation expectations also rose sharply as a result of the continuing fall in the value of sterling.

Employment has been growing steadily during 2016, despite initial expectations that the referendum would cause a fall in employment. However, the latest employment data in November, (for October), showed a distinct slowdown in the rate of employment growth and an increase in the rate of growth of the unemployment claimant count. **House prices** have been rising during 2016 at a modest pace but the pace of increase has been slowing since the referendum; a downturn in prices could dampen consumer confidence and expenditure.

USA. The American economy had a patchy 2015 with sharp swings in the quarterly **growth rate** leaving the overall growth for the year at 2.4%. Quarter 1 of 2016 at +0.8%, (on an annualised basis), and quarter 2 at 1.4% left average growth for the first half at a weak 1.1%. However, the first estimate for quarter 3 at 2.9% signalled a rebound to strong growth. The Fed. embarked on its long anticipated first increase in rates at its December 2015 meeting. At that point, confidence was high that there would then be four more increases to come in 2016. Since then, more downbeat news on the international scene and then the Brexit vote, have caused a delay in the timing of the second increase which is now strongly expected in December 2016. Overall, despite some data setbacks, the US is still, probably, the best positioned of the major world economies to make solid progress towards a combination of strong growth, full employment and rising inflation: this is going to require the central bank to take action to raise rates so as to make progress towards normalisation of monetary policy, albeit at lower central rates than prevailed before the 2008 crisis.

The result of the **presidential election** in November is expected to lead to a strengthening of US growth if Trump's election promise of a major increase in expenditure on infrastructure is implemented. This policy is also likely to strengthen inflation pressures as the economy is already working at near full capacity. In addition, the unemployment rate is at a low point verging on what is normally classified as being full employment. However, the US does have a substantial amount of hidden unemployment in terms of an unusually large, (for a developed economy), percentage of the working population not actively seeking employment.

Trump's election has had a profound effect on the **bond market and bond yields** have risen sharply in the week since his election. Time will tell if this is a temporary over reaction, or a reasonable assessment of his election promises to cut taxes at the same time as boosting expenditure. This could lead to a sharp rise in total debt issuance from the current level of around 72% of GDP towards 100% during his term in office. However, although the Republicans now have a monopoly of power for the first time since the 1920s, in having a President and a majority in both Congress and the Senate, there is by no means any certainty that the politicians and advisers he has been appointing to his team, and both houses, will implement the more extreme policies that Trump outlined during his election campaign. Indeed, Trump may even rein back on some of those policies himself.

The election does not appear likely to have much impact on the Fed. in terms of holding back further on increasing **the Fed. Rate.** Accordingly, the next rate rise is still widely expected to occur in December 2016, followed by sharper increases thereafter, which may also cause Treasury yields to rise further. If the Trump package of policies is fully implemented, there is likely to be a significant increase in inflationary pressures which could, in turn, mean that the pace of further Fed. Rate increases will be quicker and stronger than had been previously expected.

In the first week since the US election, there has been a major shift in **investor sentiment** away from bonds to equities, especially in the US. However, gilt yields in the UK and bond yields in the EU have also been dragged higher. Some commentators are saying that this rise has been an overreaction to the US election result which is likely to be reversed. Other commentators take the view that this could well be the start of the long expected eventual unwinding of bond prices propelled upwards to unrealistically high levels, (and conversely bond yields pushed down), by the artificial and temporary power of quantitative easing.

EZ. In the Eurozone, **the ECB** commenced, in March 2015, its massive €1.1 trillion programme of quantitative easing to buy high credit quality government and other debt of selected EZ countries at a rate of €60bn per month. This was intended to run initially to September 2016 but was extended to March 2017 at its December 2015 meeting. At its December and March 2016 meetings it progressively cut its deposit facility rate to reach -0.4% and its main refinancing rate from 0.05% to zero. At its March meeting, it also increased its monthly asset purchases to €80bn. These measures have struggled to make a significant impact in boosting economic growth and in helping inflation to rise significantly from low levels towards the target of 2%.

EZ GDP growth in the first three quarters of 2016 has been 0.5%, +0.3% and +0.3%, (+1.6% y/y). Forward indications are that economic growth in the EU is likely to continue at moderate levels. This has added to comments from many forecasters that those central banks in countries around the world which are currently struggling to combat low growth, are running out of ammunition to stimulate growth and to

boost inflation. Central banks have also been stressing that national governments will need to do more by way of structural reforms, fiscal measures and direct investment expenditure to support demand and economic growth in their economies.

There are also significant specific political and other risks within the EZ: -

- **Greece** continues to cause major stress in the EU due to its tardiness and reluctance in implementing key reforms required by the EU to make the country more efficient and to make significant progress towards the country being able to pay its way – and before the EU is prepared to agree to release further bail out funds.
- **Spain** has had two inconclusive general elections in 2015 and 2016, both of which failed to produce a workable government with a majority of the 350 seats. At the eleventh hour on 31 October, before it would have become compulsory to call a third general election, the party with the biggest bloc of seats (137), was given a majority confidence vote to form a government. This is potentially a highly unstable situation, particularly given the need to deal with an EU demand for implementation of a package of austerity cuts which will be highly unpopular.
- The under capitalisation of **Italian banks** poses a major risk. Some **German banks** are also undercapitalised, especially Deutsche Bank, which is under threat of major financial penalties from regulatory authorities that will further weaken its capitalisation. What is clear is that national governments are forbidden by EU rules from providing state aid to bail out those banks that are at risk, while, at the same time, those banks are unable realistically to borrow additional capital in financial markets due to their vulnerable financial state. However, they are also 'too big, and too important to their national economies, to be allowed to fail'.
- **4 December Italian constitutional referendum** on reforming the Senate and reducing its powers; this has also become a confidence vote on Prime Minister Renzi who originally said he would resign if there is a 'no' vote, but has since back tracked on that in the light of adverse poll predictions. A rejection of these proposals would stop progress to fundamental political and economic reform which is urgently needed to deal with Italy's core problems, especially low growth and a very high debt to GDP ratio of 135%. They are also intended to give Italy more stable government as no western European country has had such a multiplicity of governments since the Second World War as Italy, due to the equal split of power between the two chambers of the Parliament which are both voted in by the Italian electorate but by using different voting systems. It is unclear what the political, and other, repercussions could be if there is a 'No' vote.
- **Dutch general election 15.3.17**; a far right party is currently polling neck and neck with the incumbent ruling party. In addition, anti-big business and anti-EU activists have already collected two thirds of the 300,000 signatures required to force a referendum to be taken on approving the EU – Canada free trade pact. This could delay the pact until a referendum in 2018 which would require unanimous approval by all EU governments before it can be finalised. In April 2016, Dutch voters rejected by 61.1% an EU – Ukraine cooperation pact under the same referendum law. Dutch activists are concerned by the lack of democracy in the institutions of the EU.
- **French presidential election;** first round 13 April; second round 7 May 2017.
- **French National Assembly election June 2017.**
- **German Federal election August – 22 October 2017.** This could be affected by significant shifts in voter intentions as a result of terrorist attacks, dealing with a huge influx of immigrants and a rise in anti EU sentiment.
- The core EU, (note, not just the Eurozone currency area), principle of **free movement of people** within the EU is a growing issue leading to major stress and tension between EU states, especially with the Visegrad bloc of former communist states.

Given the number and type of challenges the EU faces in the next eighteen months, there is an identifiable risk for the EU project to be called into fundamental question. The risk of an electoral revolt

against the EU establishment has gained traction after the shock results of the UK referendum and the US Presidential election. But it remains to be seen whether any shift in sentiment will gain sufficient traction to produce any further shocks within the EU.

Asia. Economic growth in **China** has been slowing down and this, in turn, has been denting economic growth in emerging market countries dependent on exporting raw materials to China. Medium term risks have been increasing in China e.g. a dangerous build up in the level of credit compared to the size of GDP, plus there is a need to address a major over supply of housing and surplus industrial capacity, which both need to be eliminated. This needs to be combined with a rebalancing of the economy from investment expenditure to consumer spending. However, the central bank has a track record of supporting growth through various monetary policy measures, though these further stimulate the growth of credit risks and so increase the existing major imbalances within the economy.

Economic growth in Japan is still patchy, at best, and skirting with deflation, despite successive rounds of huge monetary stimulus and massive fiscal action to promote consumer spending. The government is also making little progress on fundamental reforms of the economy.

Emerging countries. There have been major concerns around the vulnerability of some emerging countries exposed to the downturn in demand for commodities from China or to competition from the increase in supply of American shale oil and gas reaching world markets. The ending of sanctions on Iran has also brought a further significant increase in oil supplies into the world markets. While these concerns have subsided during 2016, if interest rates in the USA do rise substantially over the next few years, (and this could also be accompanied by a rise in the value of the dollar in exchange markets), this could cause significant problems for those emerging countries with large amounts of debt denominated in dollars. The Bank of International Settlements has recently released a report that $340bn of emerging market corporate debt will fall due for repayment in the remaining two months of 2016 and in 2017 – a 40% increase on the figure for the last three years.

Financial markets could also be vulnerable to risks from those emerging countries with major sovereign wealth funds, that are highly exposed to the falls in commodity prices from the levels prevailing before 2015, especially oil, and which, therefore, may have to liquidate substantial amounts of investments in order to cover national budget deficits over the next few years if the price of oil does not return to pre-2015 levels.

Brexit timetable and process

- March 2017: UK government notifies the European Council of its intention to leave under the Treaty on European Union Article 50
- March 2019: two-year negotiation period on the terms of exit. This period can be extended with the agreement of all members i.e. not that likely.
- UK continues as an EU member during this two-year period with access to the single market and tariff free trade between the EU and UK.
- The UK and EU would attempt to negotiate, among other agreements, a bi-lateral trade agreement over that period.
- The UK would aim for a negotiated agreed withdrawal from the EU, although the UK may also exit without any such agreements.
- If the UK exits without an agreed deal with the EU, World Trade Organisation rules and tariffs could apply to trade between the UK and EU - but this is not certain.
- On exit from the EU: the UK parliament would repeal the 1972 European Communities Act.
- The UK will then no longer participate in matters reserved for EU members, such as changes to the EU's budget, voting allocations and policies.
- It is possible that some sort of agreement could be reached for a transitional time period for actually implementing Brexit after March 2019 so as to help exporters to adjust in both the EU and in the UK.

Annex D

Credit and Counterparty Risk Management

Permitted Investments, Associated Controls and Limits for Scottish Borders Council, Common Good and Trust Funds and In-house Managed Pension Fund

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good & Trust Fund Limits	Pension Fund In-House Limits
Cash type instruments					
a. Deposits with the Debt Management Account Facility (UK Government) (**Very low risk)**	This is a deposit with the UK Government and, as such, counterparty and liquidity risk is very low, and there is no risk to value. Deposits can be between overnight and 6 months.	Little mitigating controls required. As this is a UK Government investment, the monetary limit is unlimited to allow for a safe haven for investments.	£unlimited, maximum 6 months.	£unlimited, maximum 6 months.	£unlimited, maximum 6 months.
b. Deposits with other local authorities or public bodies **(Very low risk)**	These are considered quasi UK Government debt and, as such counterparty risk is very low, and there is no risk to value. Liquidity may present a problem as deposits can only be broken with the agreement of the counterparty, and penalties can apply. 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.	£40m, maximum 1 year.	£5m, maximum 1 year.	£40m, maximum 1 year.
c. Money Market Funds (MMFs) **(Very low risk)**	Pooled cash investment vehicle which provides very low counterparty, liquidity and market risk. These will primarily be used as liquidity instruments.	Funds will only be used where the MMFs are Constant Net Asset Value (CNAV), and the fund has a "AAA" rated status from either Fitch, Moody's or Standard & Poors.	£5m per fund/£20m overall	£5m per fund/£20m overall	£5m per fund/£20m overall

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

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good & Trust Fund Limits	Pension Fund In-House Limits
f. UK Government Gilts and Treasury Bills **(Very low risk)**	These are marketable securities issued by the UK Government and, as such, counterparty and liquidity risk is very low, although there is potential risk to value arising from an adverse movement in interest rates (no loss if these are held to maturity).	Little counterparty mitigating controls are required, as this is a UK Government investment. The potential for capital loss will be reduced by limiting the maximum monetary and time exposures.	£20m, maximum 1 year.	£5m, maximum 1 year	£20m, maximum 1 year.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good & Trust Fund Limits	Pension Fund In-House Limits
Other types of investments					
g. Investment properties **(Medium Risk)**	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 revalued regularly and reported annually with gross and net rental streams.	£30m	£25m	N/A
h. Loans to third parties, including soft loans **(Low to Medium Risk depending on Credit Risk)**	These are service investments either at market rates of interest or below market rates (soft loans). These types of investments may exhibit credit risk and are likely to be highly illiquid.	Each third party loan requires Member approval and each application is supported by the service rational behind the loan and the likelihood of partial or full default.	£25m	£1m	N/A
i. National Housing Trust **(Very Low Risk due to Scottish Government Underwriting)**	These are loans to a Special Purpose Vehicle to allow it to purchase new homes under the NHT umbrella. These loans represent either 65% or 70% of the purchase price, the remainder being funded by the developer. The loan is redeemed after a 5 to 10 year period when the properties are sold.	Loan redemption arises when the homes are sold. Interest payments are made to the Council by the SPV from rental payments in the intervening period. Both the loan amount and associated interest payments are underwritten by Scottish Government.	£8m	N/A	N/A

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good & Trust Fund Limits	Pension Fund In-House Limits
j. Loans to a local authority company or partnership **(Low Risk)**	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/LLP requires Member approval and each application is supported by the service rational/business case behind the loan and the likelihood of partial or full default. In general these loans will involve some form of security or clear cashflow that is available to service the debt.	**£25M**	N/A	N/A
k. Shareholdings in a local authority company / Corporate membership of local authority partnerships	These are service investments which may exhibit market risk and are likely to be highly illiquid.	Each equity investment in a local authority company/partnership requires Member approval and each application will be supported by the service rational behind the investment and the likelihood of loss.	**£1m**	N/A	N/A
l. Pooled Investment Vehicles **(Low to Medium Risk)**	These use an investment vehicle, for long term capital growth and income returns. These are liquid assets in the sense that there is a realizable market value, however there is a high risk of volatility in the short and medium term in relation to market values and dividend income streams.	The Common Good and Trust Funds Investment Strategy sets out the risk/return criteria and the asset allocation for these investments. It also sets out the mechanisms for monitoring and managing the performance of the funds. Using a Multi Asset fund to increase the diversification to manage the volatility risk of specific asset classes.	£0	All balances nominated by the Common Good & Trust Fund Working Groups as approved by Council up to a maximum of £7.5m.	N/A

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good & Trust Fund Limits	Pension Fund In-House Limits
m. Investment in the Subordinated Debt of projects delivered via the 'HubCo' model **(Very Low Risk)**	These are investments that are exposed to the success or failure of individual projects and are highly illiquid.	The Council and Scottish Government (via the SFT) are participants in and party to the governance and controls within the project structure. As such they are well placed to influence and ensure the successful completion of the project's term. These projects are based on robust business cases with a cashflow from public sector organisations (i.e. low credit risk)	£250,000	N/A	N/A

The Monitoring of Investment Counterparties

The status of counterparties will be monitored regularly. The Council receives credit rating and market information from 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 and if required new counterparties which meet the criteria will be added to the list.

Use of External Fund Managers

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

ANNEX E

Credit Ratings

Long and Short Term Credit Ratings

Audit Commission Grading#	Fitch		Moody's		Standard and Poor's	
	Long Term	**Short Term**	**Long Term**	**Short Term**	**Long Term**	**Short Term**
Extremely strong grade	AAA	F1+	Aaa	P-1	AAA	A-1+
Very strong grade	AA+ AA AA-	F1+ F1+ F1+	Aa1 Aa2 Aa3	P-1 P-1 P-1	AA+ AA AA-	A-1+ A-1+ A-1+
Strong grade But susceptible to adverse conditions	A+ A A-	F1+ / F1 F1 F1	A1 A2 A3	P-1 P-1 / P-2 P-1 / P-2	A+ A A	A-1+ / A-1 A-1 A-1 / A-2
Adequate Grade	BBB+ BBB BBB-	F2 F2 / F3 F3	Baa1 Baa2 Baa3	P-2 P-2 / P-3 P-3	BBB+ BBB BBB-	A-2 A-2 / A-3 A-2
Speculative Grade	BB+ BB BB-	B B B	Ba1 Ba2 Ba3	NP * NP NP	BB+ BB BB-	B-1 B-2 B-3
Very Speculative Grade	B+ B B-	B B B	Ba1 Ba2 Ba3	NP NP NP	B+ B B-	- - -
Vulnerable Grade	CCC CCC CCC CC C	C C C C C	Caa1 Caa2 Caa3 - Ca	NP NP NP NP NP	CCC+ CCC CCC- CC C	C C C C C
Defaulting Grade	D	D	C	NP	D	D

for the purpose of standardisation based on Standard and Poor's credit rating definitions.
* NP – Not Prime

Source: Audit Commission adaptation of information from Fitch, Moody's and Standard & Poor's

Viability, Financial Strength and Support Ratings

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

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

Annex F

Benchmarking and Monitoring Security, Liquidity and Yield

The consideration and approval of security and liquidity benchmarks are also part of Member reporting. These benchmarks are targets and so may be breached from time to time. Any breach will be reported, with supporting reasons, in the annual treasury report.

Yield
These benchmarks are currently widely used to assess investment performance. Local measures of yield benchmarks are:

- Investments – **Internal returns above the 7 day LIBID rate**

Security and liquidity benchmarks are already intrinsic to the approved treasury strategy through the counterparty selection criteria and some of the prudential indicators. Benchmarks for the cash type investments are below. In the other investment categories, appropriate benchmarks will be used where available.

Liquidity
This is defined as an organisation "having adequate, though not excessive, cash resources, borrowing arrangements, overdrafts or standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives" (CIPFA Treasury Management Code of Practice). In respect of liquidity, the Council seeks to maintain:

- Bank overdraft - £250,000
- Liquid short term deposits of at least £3,000,000 available with a week's notice.

The availability of liquidity in the portfolio can be benchmarked by the monitoring of the Weighted Average Life (WAL) of the portfolio – shorter WAL would generally embody less risk. In this respect, the proposed benchmark to be used is:

- **WAL benchmark is expected to be 0.5 years, with a maximum of 1.00 years**.

Security of the investments
In the context of benchmarking, assessing security is a much more subjective area to assess. Security is currently evidenced by the application of minimum credit quality criteria to investment counterparties, primarily through the use of the Creditworthiness service provided by Capita Asset Services. Whilst this approach embodies security considerations, benchmarking levels of risk is more problematic. One method to benchmark security risk is to assess the historic level of default against the minimum criteria used in the Council's investment strategy.

The Council's maximum security risk benchmark for the whole portfolio, when compared to these historic default tables, is:

- **0.04% historic risk of default when compared to the whole portfolio.**

These benchmarks are embodied in the criteria for selecting cash investment counterparties and these will be monitored and reported to Members in the Annual Treasury Management Report. As this data is collated, trends and analysis will be collected and reported.

GLOSSARY OF TERMS

CIPFA	Chartered Institute of Public Finance and Accountancy
CIPFA Code	Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes
CFR	Capital Financing Requirement is the estimated the level of borrowing or financing needed to fund capital expenditure.
Consent to Borrow	Para 1 (1) of Schedule 3 of the Local Government (Scotland) Act 1975 (the 1975 Act) effectively restricts local authorities to borrowing only for capital expenditure. Under the legislation Scottish Ministers may provide consent for local authorities to borrow for expenditure not covered by this paragraph, where they are satisfied that the expenditure should be met by borrowing.
Gilts	A gilt is a UK Government liability in sterling, issued by HM Treasury and listed on the London Stock Exchange. The term "gilt" or "gilt-edged security" is a reference to the primary characteristic of gilts as an investment: their security. This is a reflection of the fact that the British Government has never failed to make interest or principal payments on gilts as they fall due.
LIBID	London Interbank Bid Rate The rate at which banks bid on Eurocurrency Deposits, being the rate at which a bank is willing to borrow from other banks.
MPC	Monetary Policy Committee
NHT	National Housing Trust initiative undertaken in partnership with the Scottish Futures Trust.
Other Long Term Liabilities	Balance sheet items such as Public Private Partnership (PPP), and leasing arrangements which already include borrowing instruments.
PPP	Public-Private Partnership.
Prudential Indicators	The Prudential Code sets out a basket of indicators (the Prudential Indicators) that must be prepared and used in order to demonstrate that local authorities have fulfilled the objectives of the Prudential Code.
QE	Quantitative Easing
Treasury Indicators	These consist of a number of Treasury Management Indicators that local authorities are expected to 'have regard' to, to demonstrate compliance with the Treasury Management Code of Practice.

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

Capital & Investments Team, Corporate Finance, Scottish Borders Council, Council HQ, Newtown St Boswells

01835 824000, t&cteam@scotborders.gov.uk