Treasury Management and Investment Strategy 2018/19

March 2018

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Introduction

CIPFA defines treasury management as:

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

The background for the requirements strategy is set out in the in the undernoted legislation:

- Section 35 Local Government in Scotland Act 2003 - Capital Expenditure Limits;
- Schedule 3 Local Government (Scotland) Act 1975 – Powers to Borrow;
- Reporting of prudential indicators (Capital) – requirement of CIPFA Prudential Code; and
- Local Government Investments (Scotland) Regulations 2010
- Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016

South Ayrshire Council's Treasury Management and Investment Strategy for 2018/19 is set out in the following Sections 1 to 4 plus Annex A and B.

Treasury Management and Investment Strategy 2018/19

Section 1 - Capital Plans and Prudential Indicators 2017/18 to 2020/21

The Council's capital expenditure plans and delivery are the key drivers of treasury management activity. The capital expenditure plans are reflected in prudential indicators, which are designed to assist in providing Members with an overview of the Council's capital plans.

1.1 ***Capital Expenditure*** - This prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of the budget cycle.

Members are asked to approve the capital expenditure forecasts:

Capital Expenditure	***2016/17 Actual £'000***	***2017/18 Projected £'000***	***2018/19 Estimate £'000***	***2019/20 Estimate £'000***	***2020/21 Estimate £'000***
General Services	54,195	27,415	48,778	46,320	32,079
HRA	13,085	15,111	24,358	16,711	16,132
Total	**67,280**	**42,526**	**73,136**	**63,031**	**48,211**
Financed by:					
Government Grant/Other	(15,445)	(13,495)	(11,217)	(13,000)	(10,000)
Capital Receipts/Other	(4,329)	(1,155)	(4,976)	(250)	(250)
Revenue Resources	(8,859)	(14,891)	(11,003)	(4,610)	(6,168)
Net financing need for the year – (Borrowing)	**38,647**	**12,985**	**45,940**	**45,171**	**31,793**

The table above takes in to account the latest 2017/18 projections as reported at P9 for spend and any programme decisions that impact on future years. The table also summarises the capital expenditure plans and how these plans are being financed by capital or revenue resources.

Any shortfall of resources results in a funding requirement (borrowing).

Other Long Term Liabilities **(OLTL)** - The above summarised capital plan excludes other long term liabilities, such as PFI and leasing arrangements which already include borrowing instruments.

1.2 ***Borrowing and Capital Financing Requirement***

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

Any capital expenditure, which has not immediately been paid for, 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 which are financed by borrowing.

From 1 April 2016 local authorities may choose whether to use scheduled debt amortisation, (loans pool charges), or another suitable method of calculation in order to repay borrowing. (See Section 2.5)

The CFR includes any other long term liabilities (e.g. PFI schemes and finance leases). Whilst these schemes increase the CFR and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council does not require borrowing separately for these schemes.

The Council has £59.8m of such schemes within the CFR as at 31 Mar 17.

The table below shows the projected and estimated movement in the CFR based on current capital expenditure plans.

Capital Financing Requirement	***2016/17 Actual £'000***	***2017/18 Projected £'000***	***2018/19 Estimate £'000***	***2019/20 Estimate £'000***	***2020/21 Estimate £'000***
General Services	208,947	213,222	240,309	265,243	279,182
HRA	58,047	57,224	66,715	77,663	86,279
CFR	**266,994**	**270,446**	**307,024**	**342,906**	**365,461**
Other Long Term Liabilities	(59,869)	(57,574)	(55,208)	(52,769)	(50,654)
Underlying Borrowing Need	**207,125**	**212,872**	**251,816**	**290,137**	**314,807**
Movement in CFR	**27,291**	**5,747**	**38,944**	**38,321**	**24,670**

Movement in CFR represented by					
Net financing need for the year	38,647	12,985	45,940	45,171	31,793
Less scheduled debt amortisation	(11,356)	(7,238)	(6,996)	(6,850)	(7,123)
Movement in CFR	**27,291**	**5,747**	**38,944**	**38,321**	**24,670**

1.3 ***Capital Affordability Indicators***

The previous section covers the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances.

1.3.1 **Actual and Estimates of the Ratio of Financing Costs to Net Revenue Stream**

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

	2016/17 Actual %	***2017/18 Projected %***	***2018/19 Estimate %***	***2019/20 Estimate %***	***2020/21 Estimate %***
General Services	5.44	5.96	6.20	6.38	6.75
HRA	15.54	11.79	11.89	12.62	14.31
Average Rate	6.52	6.70	6.94	7.19	7.72

1.3.2 **HRA Debt Ratios**

£'000	***2016/17 Actual £'000***	***2017/18 Projected £'000***	***2018/19 Estimate £'000***	***2019/20 Estimate £'000***	***2020/21 Estimate £'000***
HRA debt	57,724	56,900	66,391	77,340	85,956
HRA revenues	29,587	29,998	30,598	31,210	31,834
Ratio of debt to revenues	1.95	1.90	2.17	2.47	2.70

£'000	***2016/17 Actual £'000***	***2017/18 Projected £'000***	***2018/19 Estimate £'000***	***2019/20 Estimate £'000***	***2020/21 Estimate £'000***
HRA debt	57,724	56,900	66,391	77,340	85,956
Number of HRA dwellings	8,075	8,093	8,062	8,171	8,181
Debt per dwelling	£7.15	£7.03	£8.23	£9.46	£10.50

All of the above indicators at 1.3 are designed to indicate the financing costs of the Council's investment plans against its revenues and that of the HRA. The

Code does not provide target figures and also states that these indicators are not comparable between authorities given the wide ranging variations in Council's historic debt and borrowing and investment plans.

Section 2 - Treasury Management

The capital expenditure plans set out in Section 1 provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the the relevant professional codes, so that sufficient cash is available to meet this service activity. This will involve both the management of the cash flow and, where capital plans require, the arrangement of approporiate borrowing facilities.

The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

2.1 *Current Portfolio Position*

The Council's treasury portfolio position as at 31 March 2017, with forward projections are summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

External Debt	***2016/17 Actual £'000***	***2017/18 Projected £'000***	***2018/19 Estimate £'000***	***2019/20 Estimate £'000***	***2020/21 Estimate £'000***
Opening Debt at 1 April	170,345	190,709	201,293	239,657	277,168
Long Term Debt Maturities	(14,636)	(4,416)	(2,636)	(7,489)	(1,004)
New External Debt	35,000	15,000	41,000	45,000	28,000
Actual External Debt	**190,709**	**201,293**	**239,657**	**277,168**	**304,164**
Other long-term liabilities (PPP + Finance Leases)	62,119	59,869	57,571	55,205	52,766
Expected change in Other Long Term Liabilities	(2,250)	(2,298)	(2,366)	(2,439)	(2,115)
Actual Debt at 31 March	**250,578**	**258,864**	**294,862**	**329,934**	**354,815**
The Capital Financing Requirement	**266,993**	**270,446**	**307,024**	**342,906**	**365,461**
Under / (Over) Borrowing	**16,415**	**11,580**	**12,162**	**12,972**	**10,646**
Cash Investments	(49,086)	(50,000)	(50,000)	(50,000)	(50,000)
Net External Debt	**141,623**	**151,293**	**189,657**	**227,168**	**254,164**

Within the prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well-defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2018/19 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

The Head of Finance and ICT reports that the Council complied with this prudential indicator in the current year. This view takes into account current commitments, existing plans, and the proposals in the budget report.

2.2 *Treasury Indicators: Limits to Borrowing Activity*

2.2.1 **The Operational Boundary** - this is the limit beyond which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt and the Council's under/over borrowed position.

Operational Boundary	***2017/18 £'000***	***2018/19 £'000***	***2019/20 £'000***	***2020/21 £'000***
Debt	212,000	250,000	287,000	314,000
Other long term liabilities	58,000	55,000	53,000	51,000
Total	**270,000**	**305,000**	**340,000**	**365,000**

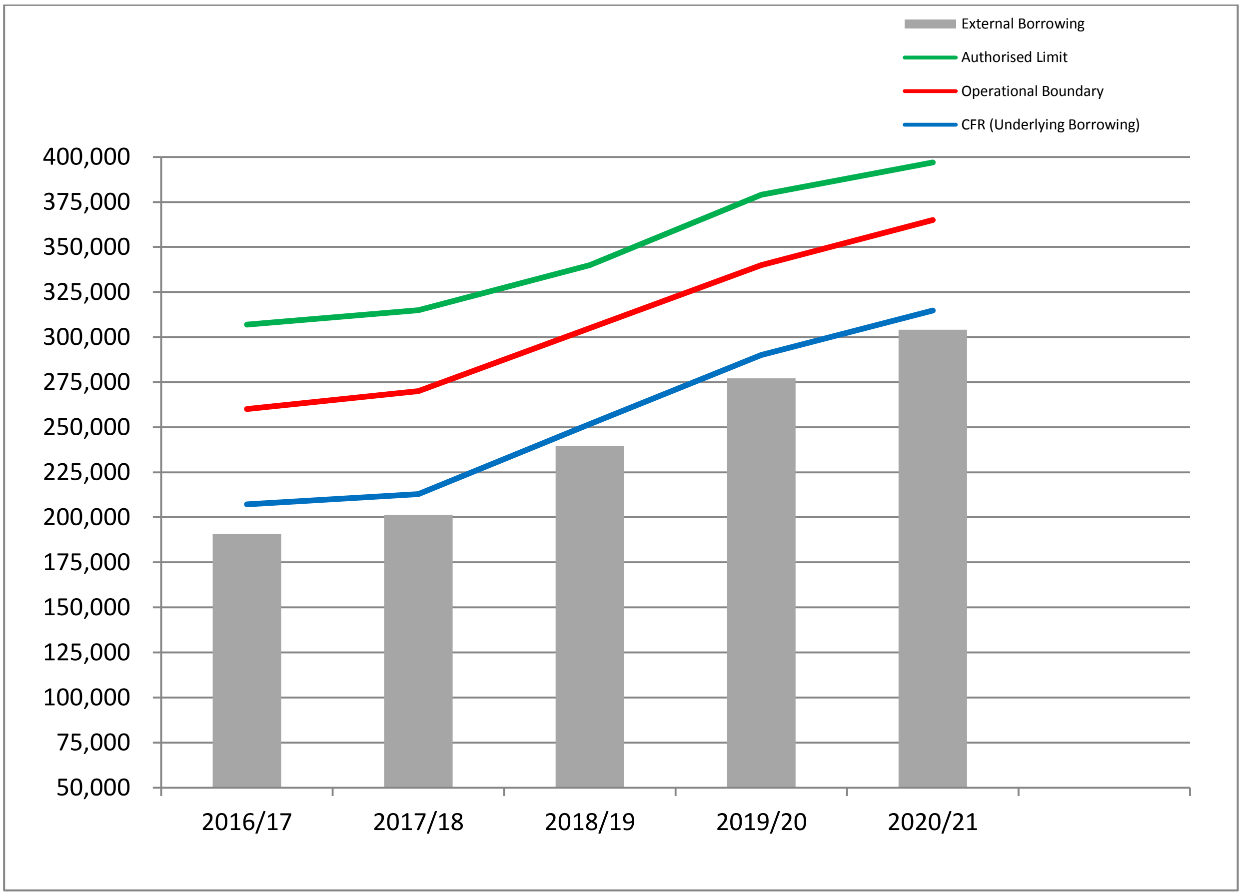
2.2.2 **The Authorised Limit for External Borrowing** - a further key prudential indicator represents a control on the maximum level of external debt. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level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

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.

Authorised limit	***2017/18 £'000***	***2018/19 £'000***	***2019/20 £'000***	***2020/21 £'000***
Debt	247,000	285,000	326,000	346,000
Other long term liabilities	58,000	55,000	53,000	51,000
Total	**315,000**	**340,000**	**379,000**	**397,000**

2.2.3 The under-noted graph shows the relationship between the 4 main components of capital financing:

- Authorised Limit (Debt);
- Operational Boundary (Debt);
- Capital Financing Requirement; and
- Actual External Debt



2.3 *Prospects for Interest Rates and Economic Commentary*

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

	Bank Rate %	***PWLB Borrowing Rates % (including certainty rate adjustment)***			
		5 year	**10 year**	***25 year***	***50 year***
Current	0.50	1.96	2.45	2.83	2.54
Mar 2018	0.50	1.90	2.50	2.80	2.60
Jun 2018	0.70	2.00	2.50	2.90	2.70
Sep 2018	0.75	2.10	2.60	3.00	2.80
Dec 2018	1.00	2.10	2.70	3.10	2.90
Mar 2019	1.00	2.20	2.70	3.20	3.00
Jun 2019	1.00	2.30	2.80	3.20	3.00
Sep 2019	1.00	2.30	2.80	3.30	3.10
Dec 2019	1.25	2.40	2.90	3.30	3.10
Mar 2020	1.25	2.40	3.00	3.40	3.20
Jun 2020	1.25	2.50	3.00	3.50	3.30
Sep 2020	1.50	2.50	3.10	3.50	3.30

2.3.1 The Monetary Policy Committee (MPC) delivered a 0.25% increase in Bank Rate at its meeting on 2 November. This removed the emergency cut in August 2016 after the EU referendum. The MPC also gave forward guidance that they expected to increase Bank rate only twice more by 0.25% by 2020 to end at 1.00%. ***At its February 2018 meeting, there was no change in Bank Rate but the forward guidance changed significantly to warn of 'earlier, and greater than anticipated' rate of increases in Bank rate compared to their previous forward guidance***. The Link Asset Services forecast as above includes increases in Bank Rate of 0.25% in May and November 2018, November 2019 and August 2020.

2.3.2 The overall longer 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 more protracted move from bonds to equities after a historic long-term trend, over about the last 25 years, of falling bond yields. The action of central banks since the financial crash of 2008, in implementing substantial Quantitative Easing, added further impetus to this downward trend in bond yields and rising bond prices. Quantitative Easing has also directly led to a rise in equity values as investors searched for higher returns and took on riskier assets. There was a sharp rise in bond yields after the US Presidential election in November 2016 and yields have risen further more recently as a result of an agreement to a big increase in the government deficit aimed at stimulating economic growth and the Federal Reserve (US Central Bank) (Fed) taking the lead in reversing monetary policy by starting, in October 2017, a policy of not fully reinvesting proceeds from bonds that it holds when they mature. We have also seen a sharp sell-off in equities and bonds in February 2018 that has given further impetus to a rise in bond yields.

2.3.3 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 stronger economic growth becomes more firmly established. The Fed has started raising interest rates and this trend is expected to continue during 2018 and 2019. These increases will 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 are likely to exert some upward pressure on bond yields in the UK and other developed economies. However, 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 towards the reversal of monetary policy away from quantitative easing and other credit stimulus measures

2.3.4 From time to time, gilt yields – and therefore PWLB rates - can be subject to exceptional levels of volatility due to geo-political, sovereign debt crisis and emerging market developments. Such volatility could occur at any time during the forecast period.

2.3.5 Economic and interest rate forecasting remains difficult with so many external influences weighing on the UK. The above forecasts (and Monetary Policy Committee (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.

2.3.6 The overall balance of risks to economic recovery in the UK is probably to the downside, particularly with the current level of uncertainty over the final terms of Brexit.

2.3.7 Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- The Bank of England takes action too quickly over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.

- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

- A resurgence of the Eurozone sovereign debt crisis, possibly Italy, due to its high level of government debt, low rate of economic growth and vulnerable banking system.

- Weak capitalisation of some European banks.

- Germany is still without an effective government after the inconclusive result of the general election in October. In addition, Italy is to hold a general election on 4 March and the anti EU populist Five Star party is currently in the lead in the polls, although it is unlikely to get a working majority on its own. Both situations could pose major challenges to the overall leadership and direction of the EU as a whole and of the individual respective countries. Hungary will hold a general election in April 2018.

- The result of the October 2017 Austrian general election has now resulted in a strongly anti-immigrant coalition government. In addition, the Czech ANO party became the largest party in the October 2017 general election on a platform of being strongly against EU migrant quotas and refugee policies. Both developments could provide major impetus to other, particularly former Communist bloc countries, to coalesce to create a major block to progress on EU integration and centralisation of EU policy. This, in turn, could spill over into impacting the Euro, EU financial policy and financial markets.

- Rising protectionism under President Trump

- A sharp Chinese downturn and its impact on emerging market countries

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

- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.

- UK inflation returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

- The Fed causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Fed Funds Rate and in the pace and strength of reversal of Quantitative Easing, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.

2.3.9 **Investment and borrowing rates**

Investment returns are likely to remain low during 2018/19 but to be on a gently rising trend over the next few years.

Borrowing interest rates

- Borrowing interest rates increased after the result of the general election in June and then also after the September MPC meeting when financial markets reacted by accelerating their expectations for the timing of Bank Rate increases. Apart from that, there has been little general trend in rates during the current financial year. 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 the future when the Council may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of 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 – the difference between borrowing costs and investment returns.

2.3.10 **Economic Commentary**

- **Global Outlook** - World growth looks to be on an encouraging trend of stronger performance, rising earnings and falling levels of unemployment. In October, the International Monetary Fund (IMF) upgraded its forecast for world growth from 3.2% to 3.6% for 2017 and 3.7% for 2018.

- **UK -** After the UK surprised on the upside with strong economic growth in 2016, growth in 2017 has been disappointingly weak; Qtr1 came in at only +0.3% (+1.8% y/y), Qtr2 was +0.3% (+1.5% y/y) and Qtr3 was +0.4% (+1.5% y/y). The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling after the EU referendum, feeding increases in the cost of imports into the economy. This has caused, in turn, a reduction in consumer disposable income and spending power and so the services sector of the economy, accounting for around 80% of GDP, has seen weak growth as consumers cut back on their expenditure.

However, more recently there have been encouraging statistics from the manufacturing sector which is seeing strong growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year while robust world growth has also been supportive. However, this sector only accounts for around 10% of GDP so expansion in this sector will have a much more muted effect on the overall GDP growth figure for the UK economy as a whole.

While the Bank of England is expected to give forward guidance to prepare financial markets for gradual changes in policy, the Monetary Policy Committee, (MPC), meeting of 14 September 2017 managed to shock financial markets and forecasters by suddenly switching to a much more aggressive tone in terms of its words around warning that Bank Rate will need to rise soon. The Bank of England Inflation Reports during 2017 have clearly flagged up that it expected CPI inflation to peak at just under 3% in 2017, before falling back to near to its target rate of 2% in two years' time. The Bank revised its forecast for the peak to just over 3% at the 14 September meeting. (Inflation actually came in at 3.1% in November so that may prove now to be the peak.) This marginal revision in the Bank's forecast can hardly justify why the MPC became so aggressive with its wording; rather, the focus was on an emerging view that with unemployment having already fallen to only 4.3%, the lowest level since 1975, and improvements in productivity being so weak, that the amount of spare capacity in the economy was significantly diminishing towards a point at which they now needed to take action.

In addition, the MPC took a more tolerant view of low wage inflation as this now looks like a common factor in nearly all western economies as a result of automation and globalisation. However, the Bank was also concerned that the withdrawal of the UK from the EU would effectively lead to a decrease in such globalisation pressures in the UK, and so this would cause additional inflationary pressure over the next few years.

At Its 2 November meeting, the MPC duly delivered a 0.25% increase in Bank Rate. It also gave forward guidance that they expected to increase Bank Rate only twice more in the next three years to reach 1.0% by 2020. This is, therefore, not quite the 'one and done' scenario but is, nevertheless, a very relaxed rate of increase prediction in Bank Rate in line with previous statements that Bank Rate would only go up very gradually and to a limited extent.

However, some forecasters are flagging up that they expect growth to accelerate significantly towards into 2018. This view is based primarily on the coming fall in inflation, (as the effect of the effective devaluation of sterling after the EU referendum drops out of the CPI statistics), which will bring to an end the negative impact on consumer spending power. In addition, a strong export performance will compensate for weak services sector growth. If this scenario was indeed to materialise, then the MPC would be likely to accelerate its pace of increases in Bank Rate during 2018 and onwards.

It is also worth noting the contradiction within the Bank of England between action in 2016 and in 2017 by two of its committees. After the shock result of the EU referendum, the Monetary Policy Committee (MPC) voted in August 2016 for emergency action to cut Bank Rate from 0.50% to 0.25%, restarting £70bn of QE purchases, and also providing UK banks with £100bn of cheap financing. The aim of this was to lower borrowing costs, stimulate demand for borrowing and thereby increase expenditure and demand in the economy. The MPC felt this was necessary in order to ward off their expectation that there would be a sharp slowdown in economic growth. Instead, the economy grew robustly, although the Governor of the Bank of England strongly maintained that this was because the MPC took that action. However, other commentators regard this emergency action by the MPC as being proven by events to be a mistake.

Then in 2017, we had the Financial Policy Committee (FPC) of the Bank of England taking action in June and September over its concerns that cheap borrowing rates, and easy availability of consumer credit, had resulted in too rapid a rate of growth in consumer borrowing and in the size of total borrowing, especially of unsecured borrowing. It, therefore, took punitive action to clamp down on the ability of the main banks to extend such credit! Indeed, a PWC report in October 2017 warned that credit card, car and personal loans and student debt will hit the equivalent of an average of £12,500 per household by 2020. However, averages belie wide variations in levels of debt with much higher exposure being biased towards younger people, especially the 25 -34 year old band, reflecting their lower levels of real income and asset ownership.

One key area of risk is that consumers may have become used to cheap rates since 2008 for borrowing, especially for mortgages. It is a major concern that some consumers may have over extended their borrowing and have become complacent about interest rates going up after Bank Rate had been unchanged at 0.50% since March 2009 until falling further to 0.25% in August 2016. This is why forward guidance from the Bank of England continues to emphasise slow and gradual increases in Bank Rate in the coming years. However, consumer borrowing is a particularly vulnerable area in terms of the Monetary Policy Committee getting the pace and strength of Bank Rate increases right - without causing a sudden shock to consumer demand, confidence and thereby to the pace of economic growth. Moreover, while there is so much uncertainty around the Brexit negotiations, consumer confidence, and business confidence to spend on investing, it is far too early to be confident about how the next two to three years will actually pan out.

Eurozone - Economic growth in the eurozone (EZ), (the UK's biggest trading partner), had been lack lustre for several years after the financial crisis despite the European Central Bank (ECB) eventually cutting its main rate to -0.4% and embarking on a massive programme of QE. However, growth picked up in 2016 and has now gathered substantial strength and momentum thanks to this stimulus. GDP growth was 0.6% in Qtr1 (2.1% y/y), 0.7% in Qtr2 (2.4% y/y) and +0.6% in Qtr3 (2.6% y/y). However, despite providing massive monetary stimulus, the European Central Bank is still struggling to get inflation up to its 2% target and in November inflation was 1.5%. It is therefore unlikely to start on an upswing in rates until possibly 2019. It has, however, announced that it will slow down its monthly QE purchases of debt from €60bn to €30bn from January 2018 and continue to at least September 2018.

USA - Growth in the American economy was notably erratic and volatile in 2015 and 2016. 2017 is following that path again with Qtr1 coming in at only 1.2% but Qtr2 rebounding to 3.1% and Qtr3 coming in at 3.3%.

Unemployment in the US has also fallen to the lowest level for many years, reaching 4.1%, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has started on a gradual upswing in rates with four increases in all and four increases since December 2016; the latest rise was in December 2017 and lifted the central rate to 1.25 – 1.50%. There could then be another four increases in 2018. At its September meeting, the Fed said it would start in October to gradually unwind its $4.5 trillion balance sheet holdings of bonds and mortgage backed securities by reducing its reinvestment of maturing holdings.

China - Economic growth has been weakening over successive years.

Japan- GDP growth has been gradually improving during 2017 to reach an annual figure of 2.1% in Qtr3. However, it is still struggling to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

Although not a matter specifically for the Council's treasury strategy given the potential impact for the UK economy overall, the under-noted provides information on the latest Brexit timetable:

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: initial two-year negotiation period on the terms of exit. In her Florence speech in September 2017, the Prime Minister proposed a two year transitional period after March 2019.

- UK continues as a full EU member until March 2019 with access to the single market and tariff free trade between the EU and UK. Different sectors of the UK economy will leave the single market and tariff free trade at different times during the two year transitional period.

- 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 could also exit without any such agreements in the event of a breakdown of negotiations.

- 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 full 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.

2.4 ***Borrowing Strategy***

At the time of writing this report, the Council is estimated to have an under-borrowed position at the end of 2017/18 of £11.580m, (5.4% of the total underlying borrowing requirement).This would mean that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with external loan debt and means that internal resources, cash and revenue surpluses have been used to finance capital expenditure. This is a prudent strategy in the current economic interest rate environment with borrowing rates significantly higher than investment rates.

During **2018/19** it is estimated that the Council and HRA will have additional borrowing requirements of £**45.939m**. The current strategy is to fund all of this new borrowing in the longer term resulting in no significant increase to the under-borrowed position or the levels of temporary loan debt which are estimated at £0.045m at the 2017/18 year end.

The treasury team are monitoring longer term interest rate forecasts on a regular basis in order to assess timing of longer term borrowing whilst still minimising the cost of carrying any new borrowing prior to the loans actually being required.

The estimates of borrowing required are set out in the under-noted table:

New Borrowing (Year)	***General Services £'000***	***HRA £'000***	***Total £'000***
2017/18	12,616	369	12,985
2018/19	35,329	10,610	45,939
2019/20	33,070	12,101	45,171
2020/21	21,829	9,964	31,793
Total 5 Yr Borrowing	**102,844**	**33,044**	**135,888**

It is emphasised that a pragmatic approach will be taken when considering the timing of this borrowing externally in the light of prevailing interest rates,the overall treasury strategy, cost of carry, and in particular the out-turn of capital expenditure as the projects are delivered in 2017/18 and 2018/19.

To assist in consideration of long term borrowing, Link Asset Services have suggested using a 'target' borrowing rate when considering funding as set out in the table below:

PWLB	*Borrowing Rate (13/02/18)*	*Target Borrowing Rate*
5 Year	1.96%	1.90%
10 Year	2.45%	2.50%
25 Year	2.83%	2.80%
50 Year	2.54%	2.60%

Although rates have risen from low points, particularly in periods up to 10 years, longer term rates are still historically low and external borrowing is currently being considered in the 40-50 year maturity periods. Value however still needs to be considered against cost of carry, the difference between investment earnings and borrowing rates, especially as the interest rate forecast indicate that Bank rate may rise only to 1.50% by March 2021.
However:

- if it was felt that there was a significant risk of a sharp fall in long and short term rates, for example, due to a marked increase of risks around relapse into recession or of risks of deflation, then long term borrowings will be postponed further, and potential rescheduling from fixed rate funding into short term borrowing will be considered; and

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

Any decisions on new borrowing will be reported to Members within the mid-year Treasury Report or the end of year out-turn report.

2.4.1 **Treasury Management Limits on Activity**

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

- Upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates based upon the debt position net of investments.

- Upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates;

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

	2017/18	***2018/19***	***2019/20***	***2019/21***
Interest Rate Exposures				
	Upper	**Upper**	**Upper**	**Upper**
Limits on fixed interest rates based on net debt	100%	100%	100%	100%
Limits on variable interest rates based on net debt	25%	25%	25%	25%

Maturity Structure of Fixed Interest Rate Borrowing		
	Lower	**Upper**
Under 12 months	0.00%	25%
1 – 2 years	0.00%	25%
2 – 5 years	0.00%	50%
5 – 10 years	0.00%	75%
10 years and above	0.00%	90%

2.5 ***Statutory Repayment of Loans Fund Advances***

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

A variety of options are provided to Councils so long as a prudent provision is made each year.

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

For loans fund advances made before 1 April 2016, the policy will be to maintain the practice of previous years and apply the Statutory Method (option a), with all loans fund advances being repaid by the annuity method.

For loans fund advances made after 1 April 2016, the policy for the repayment of loans advances will be the Asset Life method – (Option c)

a. **Statutory method** – loans fund advances will be repaid in equal instalments of principal by the annuity method. The Council is permitted to use this option for a transitional period only, of five years until 31st March

2021, at which time it must change its policy to use alternative approaches based on depreciation, asset life periods or a funding/income profile;

b. **Depreciation method** – annual repayment of loans fund advances will follow standard depreciation accounting procedures ;

c. **Asset life method** – loans fund advances will be repaid with reference to the life of an asset using either the equal instalment or annuity method;

d. **Funding / Income profile method** – loans fund advances will be repaid by reference to an associated income stream.

Finance Circular 7/2016 suggests Councils set out additional disclosures on loans fund account information, so the proposed disclosure note below has been provided to assist. Paragraph 89 of the Finance Circular also states, 'a local authority should set out their policy on the interest rate selected for the annuity calculation'.

The annuity rate applied to the loans fund repayments was based on historic interest rates and is currently 5%. However, under regulation 14 (2) of SSI 2016 No 123, the Council has reviewed and re-assessed the historic annuity rate to ensure that it is a prudent application.

The result of this review suggests that an annuity rate of 5% would remain a prudent approach and provides for principal repayments closely associated with the use of the assets.

Loans Fund Advances to General Fund

Loans Fund	31 March 2016 £'000	Est 2017/18 £'000	Est 2018/19 £'000	Est 2019/20 £'000	Est 2020/21 £'000
Opening Balance	117,692	147,011	153,582	183,034	210,382
Add advances	36,298	12,616	35,329	33,070	21,829
Less repayments	(6,979)	(6,045)	(5,877)	(5,722)	(5,801)
Closing Balance	**147,011**	**153,582**	**183,034**	**210,382**	**226,410**

Loans Fund Advances to HRA

Loans Fund	31 March 2017 (£'000)	Est 2017/18	Est 2018/19	Est 2019/20	Est 2020/21
Opening Balance	57,542	57,725	56,901	66,392	77,340
Add advances	2,350	369	10,610	12,101	9,964
Less repayments	(2,167)	(1,193)	(1,119)	(1,153)	(1,348)
Closing Balance	**57,725**	**56,901**	**66,392**	**77,340**	**85,956**

2.6 *Policy on Borrowing in Advance of Need*

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

Borrowing in advance will be made within the constraints that:

- It will be limited to no more than 20% of the expected increase in borrowing need (CFR) over the three year planning period; and

- Would not look to borrow more than 12 months in advance of need.

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

2.7 *Debt Rescheduling*

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

The reasons for any rescheduling to take place will include:

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

Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt. All rescheduling will be reported to Members in the mid-year or year-end treasury reports.

Section 3 – Annual Investment Strategy

3.1 *Investment Policy*

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 Public Services Code of Practice and Cross Sectoral Guidance Notes, ('the CIPFA TM Code'). The Council's investment priorities will be security first, liquidity second and then return.

In accordance with guidance from the Scottish Government and CIPFA, and in order to minimise the risk to investments, the Council 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 Term and Long Term credit ratings.

Ratings will not be the sole determinant of the quality of an institution; it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To this end the Council will engage with its advisors to maintain a monitor on market pricing such as ‘credit default swaps’ and overlay that information on top of the credit ratings.

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

Investment instruments identified for use in the financial year are set out in the section Permitted Investments at Annex A .Counterparty limits will be as set through the Council’s treasury management practices – schedules.

3.2 *Credit Worthiness Policy*

3.2.1 The Council applies the credit worthiness service provided by Link Asset Services (CAS). This service employs a sophisticated modelling approach utlilising credit ratings from the three main credit rating agencies - Fitch, Moodys and Standard and Poors. The credit ratings of counterparties are supplemented with the following overlays:

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

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

The Council will therefore use counterparties within the following durational bands:

- Yellow - 5 years
- Dark Pink 5 years for Ultra short dated bond funds with a credit score of 1.25

- Light Pink 5 years for Ultra short dated bond funds with a credit score of 1.5
- Purple - 2 years
- Blue - 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange - 1 year
- Red - 6 months
- Green - 100 days
- No Colour - not used

3.2.2 The under-noted table sets out the monetary limits that will be applied to each counterparty within each colour on the creditworthiness matrix.

Applying the criteria in the under-noted table has been derived from the Council's current investment activities in terms of funds available for investment, and cash flow requirements. This policy also provides a clear defined policy on investment activity limits.

	Colour Code *(Based on credit information)*	***Limit per Counterparty***	***Maximum Maturity Period***
Banks/ Building Societies	Yellow	£25m	5 Years
Banks – (UK Part Nationalised)	Blue	£25m	1 Year
Banks/ Building Societies	Purple	£20m	2 Years
Banks/ Building Societies	Orange	£15m	1 Years
Banks/ Building Societies	Red	£10m	6 months
Banks/ Building Societies	Green	£5m	100 days
Banks/ Building Societies	No Colour	£0	0 days
Council's Corporate Bankers	Orange	£50m	1 Year
Debt Management Account – UK Treasury	AA+	unlimited	6 months
Local / Public Authorities	N/A	£10m	2 Years
Money Market Funds CNAV	AAA	£20m	Liquid
Money Market Funds LVNAV	AAA	£10m	Liquid
Money Market Funds VNAV	AAA	£10m	Liquid
Ultra short dated bond funds with a credit score of 1.25	Dark Pink/ AAA	£10m	Liquid
Ultra short dated bond funds with a credit score of 1.25	Light Pink/ AAA	£10m	Liquid

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

Typically the minimum credit ratings criteria the Council use will be a Short Term rating (Fitch or equivalents) of 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.

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

- If a downgrade results in the counterparty / investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.

- in addition to the use of credit ratings the Council will be advised of information in movements in credit default swap spreads against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

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

3.3 ***Country Limits – Credit Worthiness***

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

The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA- from Fitch Rating Agency. The list of countries that qualify using this credit criteria as at the date of this report are shown below.

This list will be adjusted should ratings change in accordance with this policy.

Rating	***Country***				
AAA	Australia	Canada	Denmark	Germany	Luxembourg
	Netherlands	Norway	Singapore	Sweden	Switzerland
AA+	Finland	Honk Kong	USA		
AA	Abu Dhabi (UAE)	France	UK		
AA-	Belgium	Qatar			

3.4 ***Investment Strategy***

In-House Funds - Investments will be made with reference to the core cash balances available, cash flow requirements and the outlook for short-term interest rates (ie rates for investments up to 12 months).

Bank Rate and Investment Returns Expectations - Bank Rate is forecast to increase to 0.75% by June 18 with further increases in Dec 18 and Dec 19.

- Qtr1 2018 – 0.50%
- Qtr1 2019 – 1.00%
- Qtr1 2020 – 1.25%
- Qtr1 2021 – 1.50%

The Council will therefore budget for return on investments in the medium term as follows, with performance being measured against the published benchmark of 3 month LIBID.

- 2018/19 - 0.80%
- 2019/20 – 1.25%
- 2020/21 – 1.50%
- 2021/22 – 1.65%

The overall balance of risks to these forecasts is currently probably slightly skewed to the upside and are dependent on how strong GDP growth out-tuns, how quickly inflation pressures rise, and how quickly the Brexit negotiations move forward positively.

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

Maximum principal sums invested > 365 days			
	2018/19 £m	***2019/20 £m***	***2020/21 £m***
Principal sums invested > 364 days	£0.233m	£0.233m	£0.233m

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

3.5 ***Investment – Cash Liquidity***

A key responsibility of the Treasury function is to ensure the Council maintains adequate liquidity of cash to ensure its payment obligations can be fully met at all times. This liquidity of cash is required on a daily basis to meet the cash flow requirements of payments to employees, suppliers, agencies, re-payment of loan interest and benefits etc.

The Council does not currently utilise an overdraft facility from its bankers, Bank of Scotland as liquidity cash is available using investment accounts. Additionally the Council has access to short term loan funding from the money markets when required.

Liquidity - in respect of this area the Council seeks to maintain:

- Bank overdraft - £0.00m; and
- Liquidity cash available of £10m.

3.6 ***End of Year Investment Report***

At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report. This report will be submitted to the Council's Audit and Governance Panel and South Ayrshire Council prior to 30 September following the end of each financial year (or as soon as practicable depending on Council meeting dates)

Section 4 – Governance Arrangements

4.1 ***Financial Regulations***

The Financial Regulations set out the responsibilities of the Council and the Audit and Governance Panel in respect of treasury matters as follows:

4.1.1 **Full Council**

- receiving and reviewing reports on treasury management policies, practices and activities; and
- approval of annual strategy, a mid year review and annual report.

4.1.2 **Audit and Governance Panel**

- Responsibility for ensuring effective scrutiny of treasury management strategy, policy and operations.

4.2 ***Role of the Section 95 Officer – Head of Finance and ICT***

The S95 (responsible) officer has authority through the Scheme of Delegation and the Financial Regulations for the day to day execution and administration of treasury management decisions in line with the Council's Strategy and Treasury Management Practices. This includes:

- recommending clauses, treasury management policy for approval, reviewing the same regularly, and monitoring compliance;
- submitting regular treasury management policy reports;

- submitting budgets and budget variations;
- receiving and reviewing management information reports;
- reviewing the performance of the treasury management function;
- ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function;
- ensuring the adequacy of internal audit, and liaising with external audit; and
- recommending the appointment of external service providers.

The above list of specific responsibilities of the S95 officer in the 2017 Treasury Management Code has not changed. However, implicit in the changes in both codes, is a major extension of the functions of this role, especially in respect of non-financial investments, (which CIPFA has defined as being part of treasury management).

- preparation of a capital strategy to include capital expenditure, capital financing, non-financial investments and treasury management, with a long term timeframe (say 20+ years – to be determined in accordance with local priorities. *Please also note that CIPFA has provided advice that it recognises that it may be too late in the current budget round for 2018/19 for many local authorities to produce a capital strategy this year.)*

- ensuring that the capital strategy is prudent, sustainable, affordable and prudent in the long term and provides value for money

- ensuring that due diligence has been carried out on all treasury and non-financial investments and is in accordance with the risk appetite of the authority

- ensure that the authority has appropriate legal powers to undertake expenditure on non-financial assets and their financing

- ensuring the proportionality of all investments so that the authority does not undertake a level of investing which exposes the authority to an excessive level of risk compared to its financial resources

- ensuring that an adequate governance process is in place for the approval, monitoring and ongoing risk management of all non-financial investments and long term liabilities

- provision to Members of a schedule of all non-treasury investments including material investments in subsidiaries, joint ventures, loans and financial guarantees (We are unclear as to whether CIPFA requires this to be implemented in 2018/19. We are concerned that many local authorities could have difficulty in complying fully with this requirement at this late stage in the 2018/19 budget cycle.)

- ensuring that Members are adequately informed and understand the risk exposures taken on by an authority

- ensuring that the authority has adequate expertise, either in house or externally provided, to carry out the above

Creation of Treasury Management Practices which specifically deal with how non treasury investments will be carried out and managed, to include the following:

- Risk management (TMP1 and schedules), including investment and risk management criteria for any material non-treasury investment portfolios;

- Performance measurement and management (TMP2 and schedules), including methodology and criteria for assessing the performance and success of non-treasury investments;

- Decision making, governance and organisation (TMP5 and schedules), including a statement of the governance requirements for decision making in relation to non-treasury investments; and arrangements to ensure that appropriate professional due diligence is carried out to support decision making;

- Reporting and management information (TMP6 and schedules), including where and how often monitoring reports are taken;

- Training and qualifications (TMP10 and schedules), including how the relevant knowledge and skills in relation to non-treasury investments will be arranged.

4.3 ***Policy on the Use of External Service Providers***

The Council uses Link 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 undue reliance is not placed upon external service providers.

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

4.4 ***Training***

The CIPFA Code requires the responsible officer to ensure that Members with responsibility for treasury management receive adequate training. This especially applies to Members responsible for scrutiny of the treasury function.

Training sessions for both the Council’s Corporate Management Team and Members were held in November 2017, with further training being reviewed as required.

Permitted Investments

The Council approves the following forms of investment instrument for use as permitted investments as set out in **Table 1 -7**

Treasury risks

All the investment instruments in Table 1 are subject to the following risks:

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

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

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

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

e. **Legal and regulatory risk:** this is the risk that the organisation itself, or an organisation powers or regulatory requirements, and that the organisation suffers losses accordingly.

Controls on treasury risks

a. **Credit and counter-party risk**: this authority has set minimum credit criteria to determine which counterparties and countries are of sufficiently high creditworthiness to be considered for investment purposes. See paragraphs 4.2 and 4.3.

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

c. **Market risk:** this Council does not purchase investment instruments which are subject to market risk in terms of fluctuation in their value.

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

e. **Legal and regulatory risk:** the Council will not undertake any form of investing until it has ensured that it has all necessary powers and also complied with all regulations.

Unlimited investments

Regulation 24 states that an investment can be shown as being ‘unlimited’ in terms of the maximum amount or percentage of the total portfolio that can be put into that type of investment.

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

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

b. **High credit worthiness banks and building societies.** See Section 3.2 relating to creditworthiness. While an unlimited amount of the investment portfolio may be put into banks and building societies with high credit worthiness, the Council will ensure diversification of its portfolio ensuring that no more than 50% of the total portfolio can be placed with any one institution or group at any one time.

Objectives of each type of investment instrument

Regulation 25 requires an explanation of the objectives of every type of investment instrument which an authority approves as being ‘permitted’. (Part 1 section 17 also requires authorities to explain any special circumstances that have led them to a particular approach.

1. Deposits

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

a. **Debt Management Agency Deposit Facility -** This offers the lowest risk form of investment available to local authorities as it is effectively an investment placed with the Government. It is also easy to use as it is a deposit account and avoids the complications of buying and holding Government issued treasury bills or gilts. As it is low risk it also earns low rates of interest. However, it is very useful for authorities whose overriding priority is the avoidance of risk. The longest period for a term deposit with the DMADF is 6 months.

b. **Term deposits with high credit worthiness banks and building societies -** See paragraph 3.2 for an explanation of this authority's definition of high credit worthiness. This is the most widely used form of investing used by local authorities. It offers a much higher rate of return than the DMADF (dependent on term). The Council will ensure diversification of its portfolio of deposits ensuring that no more than 50% of the total portfolio can be placed with any one institution or group. In addition, longer term deposits offer an opportunity to increase investment returns by locking in high rates ahead of an expected fall in the level of interest rates. At other times, longer term rates can offer good value when the markets incorrectly assess the speed and timing of interest rate increases. This form of investing therefore, offers a lot of flexibility and higher earnings than the DMADF. Where it is restricted is that once a longer term investment is made, that cash is locked in until the maturity date.

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

Fixed term deposits with variable rate and variable maturities (structured deposits). This line encompasses ALL types of structured deposits. There has been considerable change in the types of structured deposits brought to the market over the last few years, some of which are already no longer available. In view of the fluidity of this area, this is a generic title for all structured deposits so as to provide Councils with greater flexibility to adopt new instruments as and when they are brought to the market.

d. **Collateralised deposits.** These are deposits placed with a bank which offers collateral backing based on specific assets. Examples seen in the past have included local authority LOBOs, where such deposits are effectively lending to a local authority as that is the ultimate security.

2. **Deposits with Counterparties currently in receipt of Government Support/ Ownership**

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

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

b. **Fixed term deposits with variable rate and variable maturities (structured deposits).** This line encompasses ALL types of structured deposits. There has been considerable change in the types of structured deposits brought to the market over the last few years, some of which are already no longer available. In view of the fluidity of this area, this is a generic title for all structured deposits so as to provide Councils with greater flexibility to adopt new instruments as and when they are brought to the market.

3. **Collective Investment Schemes structured as Open Ended Investment Companies (OEICs)**

a. **Government liquidity funds.** These are the same as money market funds (see below) but only invest in government debt issuance with highly rated governments. Due to the higher quality of underlying investments, they offer a lower rate of return than MMFs. However, their net return is typically on a par with the DMADF, but with instant access.

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

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

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

e. **Bond funds.** These can invest in both government and corporate bonds. This therefore entails a higher level of risk exposure than gilt funds and the aim is to achieve a higher rate of return than normally available from gilt funds by trading in non-government bonds.

4. Securities Issued or Guaranteed by Governments

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

a. **Treasury bills.** These are short term bills (up to 12 months, although none have ever been issued for this maturity) issued by the Government and so are backed by the sovereign rating of the UK. The yield is higher than the rate of interest paid by the DMADF and another advantage compared to a time deposit in the DMADF is that they can be sold if there is a need for access to cash at any point in time. However, there is a spread between purchase and sale prices so early sales could incur a net cost during the period of ownership.

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

c. **Bond issuance issued by a financial institution which is explicitly guaranteed by the UK Government** e.g. National Rail. This is similar to gilt due to the explicit Government guarantee.

d. **Sovereign bond issues (other than the UK govt) denominated in Sterling.** As for gilts but issued by other nations. Use limited to issues of nations with at least the same sovereign rating as for the UK.

e. **Bonds issued by Multi-Lateral Development Banks (MLDBs).** These are similar to c.and e. above but are issued by MLDBs which are typically guaranteed by a group of sovereign states e.g. European Bank for Reconstruction and Development.

5 Securities issued by Corporate Organisations

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

a. **Certificates of deposit (CDs).** These are shorter term securities issued by deposit taking institutions (mainly financial institutions). They are negotiable instruments, so can be sold ahead of maturity and also purchased after they have been issued. However, that liquidity can come at a price, where the yield could be marginally less than placing a deposit with the same bank as the issuing bank.

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

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

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

6 Other

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

Deposits

Table 1	***Liquidity risk***	***Market risk***	***Max % of total investment***	***Max. maturity***
Debt Management Agency Deposit Facility	Term	no	100%	6 months
Term deposits – local / public authorities	Term	no	100%	2 years
Call accounts – banks and building societies	Instant	no	100%	N/A
Term deposits – banks and building societies	Term	no	100%	See Credit Policy (colour code)
Fixed term deposits with variable rate and variable maturities: Structured deposits.	Term	no	10%	See Credit Policy (colour code)

Deposits with Counterparties Currently in Receipt of Government Support/ Ownership

Table 2	***Liquidity risk***	***Market risk***	***Max % of total investment***	***Max. maturity period***
UK Part Nationalised Banks	Term	no	100%	See Credit Policy (colour code)
Banks nationalised by high credit rated (sovereign rating) countries – non UK	Term	no	100%	See Credit Policy (colour code)
Fixed term deposits with variable rate and variable maturities: Structured deposits	Term	Yes	10%	See Credit Policy (colour code)

Collective Investment schemes structured as Open Ended Investment Companies (OEIC's)

Table 3	Liquidity risk	Market risk	Max % of total investment	Max. maturity period
Government Liquidity Funds	Instant	See Section 3	20%	See credit policy
Money Market Funds (CNAV)	Instant	See Section 3	100%	See credit policy
Money Market Funds LVNAV	Instant	See Section 3	50%	See credit policy
Money Market Funds VNAV	Instant	See Section 3	50%	See credit policy
Ultra short dated bond funds with a credit score of 1.25	T+1 – T+5	See Section 3	50%	See credit policy
Ultra short dated bond funds with a credit score of 1.50	T+1 – T+5	See Section 3	50%	See credit policy
Bond Funds	Min T+2	See Section 3	50%	See credit policy
Gilt Funds	Min T+2	See Section 3	50%	See credit policy

Securities issued or guaranteed by governments

Table 4	***Minimum Credit Criteria***	***Liquidity risk***	***Market Risk***
Treasury Bills	UK sovereign	Sale T+1	Yes
UK Government Gilts	UK Sovereign	Sale T+1	Yes
Bond issuance issued by a financial institution which is guaranteed by UK Government e.g. National Rail	UK Sovereign	Sale T+3	Yes
Sovereign Bond issues (other than UK Government)	AAA	Sale T+1	Yes
Bonds issued by multi-lateral development banks	AAA	Sale T+1	Yes

Securities issued by corporate organisations

Table 5	***Liquidity risk***	***Market risk***	***Max % of total investment***
Certificates of deposit issued by banks and building societies	Sale T+1	yes	20%
Commercial Paper	Sale T+1	yes	20%
Floating Rate Notes	Sale T+0	yes	20%
Corporate bonds	T +3	Yes	20%

Other

Table 6	***Liquidity risk***	***Market risk***	***Max % of total investment***	***Max. maturity period***
Property Funds	Variable	Yes	20%	3-5 Yrs
Local Authority Mortgage Scheme	Variable	Yes	20%	25Yrs

3.5 ***Accounting Treatment of Investments***

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

Treasury Management Practice – Credit and Counterparty Risk Management

South Ayrshire Council and Common Good Funds Permitted Investments, Associated Controls

Type of Investment	*Treasury Risks*	*Mitigating Controls*	*Council Limits*	*Common Good Limits*
Cash type instruments				
a. Deposits with the Debt Management Account Facility (UK Government) *(***Very low risk)**	This is a deposit with the UK Government and as such counterparty and liquidity risk is very low, and there is no risk to value. Deposits can be between overnight and 6 months.	Little mitigating controls required. As this is a UK Government investment the monetary limit is unlimited to allow for a safe haven for investments.	Unlimited	Unlimited
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.	£20m per counterparty – 2 Years	£20m per counterparty – 2 Years
c. Money Market Funds (MMFs) **(Low to 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 has an ‘AAA’ rated status from Fitch, Moody’s or Standard and Poor’s.	£20m	£20m

Type of Investment	***Treasury Risks***	***Mitigating Controls***	***Council Limits***	***Common Good Limits***
d. Ultra short dated bond funds **(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 has an 'AAA' rated status from Fitch, Moody's or Standard and Poor's.	£10m	£10m
e. Call account deposit accounts with financial institutions (banks and building societies) **(Low risk depending on credit rating)**	These tend to be low risk investments, but will exhibit higher risks than categories (a), (b) and (c) above. Whilst there is no risk to value with these types of investments, liquidity is high and investments can be returned at short notice.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's. The selection defaults to the lowest available credit rating to provide additional risk control measures. On day to day investment dealing with these criteria will be further strengthened by the use of additional market intelligence.	See credit policy	See credit policy
f. Term deposits with financial institutions (banks and building societies) **(Low to medium risk depending on period and credit rating)**	These tend to be low risk investments, but will exhibit higher risks than categories (a), (b) and (c) above. Whilst there is no risk to value with these types of investments, liquidity is low and term deposits can only be broken with the agreement of the counterparty, and penalties may apply.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's. The selection defaults to the lowest available credit rating to provide additional risk control measures. On day to day investment dealing with these criteria will be further strengthened by the use of additional market intelligence.	See credit policy	See credit policy

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

Type of Investment	*Treasury Risks*	*Mitigating Controls*	*Council Limits*	*Common Good Limits*
		On day to day investment dealing with these criteria will be further strengthened by the use of additional market intelligence.		
j. Corporate bonds **(Medium to high risk depending on period and credit rating)**	These are marketable securities issued by financial and corporate institutions. Counterparty risk will vary and there is risk to value of capital loss arising from selling ahead of maturity if combined with an adverse movement in interest rates. Liquidity risk will be low.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's. . Corporate bonds will be restricted to those meeting the base criteria. Day to day investment dealing with these criteria will be further strengthened by the use of additional market intelligence.	See credit policy	See credit policy

Other types of Investment

Type of Investment	**Credit Criteria**	**Liquidity Risk**	**Market Risk**	**Mitigating Controls**	**Council Limits**
Common Good	Not applicable	Not applicable	No	Any Common Good, loan or investment would be subject to a separate panel report and the approval of Members before progressing. Each loan would therefore be assessed on a case by case basis and be supported by the rationale behind the investment and likelihood of any loss.	Term – 20 years - unlimited
Registered Social Landlord	Not applicable	Not applicable	No	Any RSL loan or investment would be subject to a separate panel report and the approval of Members before progressing. Each loan would therefore be assessed on a case by case basis and be supported by the rationale behind the investment and likelihood of any loss.	Term – 20 years - unlimited

Type of Investment	Credit Criteria	Liquidity Risk	Market Risk	Mitigating Controls	Council Limits
Third Party (Soft Loans)	Not applicable	Not applicable	No	Any third party loan or investment would be subject to a separate panel report and the approval of Members before progressing. Each loan would therefore be assessed on a case by case basis and be supported by the rationale behind the investment and likelihood of any loss.	Term – 5 years - £1m
hubSW/ SFT Project Investment	Not applicable	Minimum 25 years term	No	Investment is subject to a separate panel report and the approval of Members before progressing. The investment would therefore be assessed on a case basis and be supported by the rationale behind the investment and likelihood of any loss.	Term – 25 years - £1m

The Monitoring of Investment Counterparties - The status of counterparties will be monitored regularly. The Council receives credit rating and market information from Link Asset Services, including when ratings change, and counterparties are checked promptly.

On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the Head of Finance and ICT, and if required new counterparties which meet the criteria will be added to the list.