TREASURY MANAGEMENT STRATEGY 2018/19

1. Purpose of Report

1.1 This report provides Members with details of the Treasury Management Strategy for the upcoming financial year and the prudential indicators supporting the Council's agreed capital investment strategy.

1.2 In line with requirements, this report requires to be considered by both Policy and Resources and Full Council. At the 22 March 2018 meeting of the Policy and Resources Committee Members considered this report.

2. Recommendations

Members are asked to:

2.1 agree the Council's Treasury Management Strategy Statement incorporating the Prudential Indicators and Annual Investment Strategy for 2018/19, as detailed in the **Appendix** to this report;

2.2 agree that the counterparty limit with the Council's bank (Bank of Scotland) be increased from £20 million to £25 million on a permanent basis, as detailed in 4.6 below;

2.3 note that both the prudential indicators and treasury management activities will be subject to continual monitoring and, where appropriate, amendment during the course of the upcoming financial year.

3. Considerations

3.1 The Local Government in Scotland Act 2003 and supporting regulations require the Council to 'have regard to' the 'Prudential Code for Capital Finance in Local Authorities' published by the Chartered Institute of Public Finance and Accountancy (CIPFA) and therefore to set Prudential and Treasury Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable. They also require the Council to have regard to the "Treasury Management in the Public Services: Code of Practice and Cross-sectoral Guidance Notes" published by CIPFA which require the Council to set out its treasury management strategy for borrowing and investment and how it will give priority to security and liquidity in managing its investments.

The Treasury Management Strategy

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

3.3 The Council annually sets out its treasury strategy for borrowing and prepares an Annual Investment Strategy setting out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.

3.4 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised November 2009) was adopted by this Council on 30 March 2010. The primary requirements of the Code are as follows:

(a) Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.

(b) Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.

(c) Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy - for the year ahead, a Mid-year Review Report and an Annual Report (stewardship report) covering activities during the previous year.

(d) Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

(e) Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Policy & Resources Committee/Full Council.

The Prudential Indicators

3.5 The purpose of the prudential indicators is to provide assurance that the Council's capital investment plans are prudent, affordable and sustainable and it is a requirement of the Prudential Code that these indicators are formally approved by the Council.

3.6 A further key objective of the prudential indicators is to ensure that treasury management decisions are taken in accordance with good professional practice. The Prudential Code also has the objectives of being consistent with and supporting local strategic planning, local asset management planning and proper option appraisal.

4. Key Issues

4.1 The Capital Investment Strategy provides the basis for, and is informed by, both the prudential indicators and the Treasury Management Strategy.

4.2 Full Council, at its meeting of 27 February 2018, agreed the Council's Capital Programme for the 3 year period 2018/19 – 2020/21 within an indicative 10 year Capital Investment Strategy.

4.3 The capital programme agreed for 2018/19 – 2020/21 forms the basis of the prudential indicators reflected in Sections 2 and 3 of the **Appendix** to this report.

4.4 The Capital Investment Strategy agreed by the Full Council reflects the level of capital spending and associated borrowing required to meet planned investment including the completion of the Dumfries Learning Town Programme and progression of various flood prevention schemes. The need to ensure that capital spending remains within prudent, affordable and sustainable levels was recognised by Members when determining that strategy and the borrowing, and associated loan charges implications, associated with that investment are clearly identified within the agreed proposals. The Capital Investment Strategy and associated borrowing requirements will continue to be closely monitored as capital funding requirements are clarified, particularly in relation to the period beyond the upcoming financial year.

4.5 The Council's Annual Treasury Management Strategy and Annual Investment Strategy for the upcoming financial year shown in Section 4 of the **Appendix** to this report covers the following areas:-

- treasury limits in force which will limit the treasury risk and activities of the Council;
- the current treasury position;
- capital borrowings required;
- Prudential and Treasury Indicators;
- prospects for interest rates;
- capital borrowing and portfolio strategy;
- borrowing in advance of need;
- debt rescheduling opportunities;
- investments strategy.
- creditworthiness policy
- policy on use of external service providers

4.6 At the Policy and Resources Committee on 16 November 2017 Members agreed a proposal in The Treasury Management Mid-Year Review 2017/18 that the counterparty limit with the Council's bank (Bank of Scotland) be increased from £20M to £25M for a 6 month period. Following an assessment by the Head of Finance and Procurement it is proposed that the increased counterparty limit of £25M with the Bank of Scotland be made permanent. This will allow the Council to continue to operate normal current account banking and overnight facilities as well as utilise short-term investment opportunities. This limit will be kept under continual review.

4.7 In recognition of the continuation of historically low interest rates, both the Treasury Management Strategy and the Investment Management Strategy largely continue the approach adopted in the current financial year.

4.8 Monitoring of the Capital Investment Strategy, the Prudential Indicators and the Treasury Management Strategy will be undertaken through the Policy & Resources Committee/Full Council over the upcoming financial year.

5. Goverance Assurance

This is a procedural report and did not require consultation.

6. Impact Assessment

As this report does not propose a change in policy, the formal adoption of a plan, policy or strategy it is not necessary to complete an Impact Assessment.

Author

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Approved by

NAME	DESIGNATION
Paul Garrett	**Head of Finance & Procurement**

APPENDICES - 1
Treasury Management Strategy Statement and Annual Investment Strategy 2017/18

Background papers –
Minute of Policy and Resources Committee, Item 8 – 16 November 2017 -
http://egenda.dumgal.gov.uk/aksdumgal/users/public/admin/kab12.pl?cmte=PRC&meet=53&arc=71
Dumfries and Galloway Council, Item 8 – 27 February 2018 -
http://egenda.dumgal.gov.uk/aksdumgal/users/public/admin/kab14.pl?operation=SUBMIT&meet=175&cmte=COU&grpid=public&arc=71

Treasury Management Strategy Statement And Annual Investment Strategy 2018/19

Corporate Services
Finance and Procurement
Treasury and Capital
Version 1.0 (March 2018)

Contents

1.0 Introduction

1.1 Introduction

The Local Government in Scotland Act 2003 and supporting regulations require the Council to ‘have regard to’ the ‘Prudential Code for Capital Finance in Local Authorities’ published by the Chartered Institute of Public Finance and Accountancy (CIPFA) and therefore to set Prudential and Treasury Indicators for the next three years to ensure that the Council’s capital investment plans are affordable, prudent and sustainable. They also require the Council to have regard to the “Treasury Management in the Public Services: Code of Practice and Cross-sectoral Guidance Notes” published by CIPFA which require the Council to set out its treasury management strategy for borrowing and investment and how it will give priority to security and liquidity in managing its investments.

1.2 Background

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

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

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.”*

1.3 Reporting Requirements

The Council is currently required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of polices, estimates and actuals.
Prudential and treasury indicators and treasury strategy (this report) - The first, and most important report covers:

- the capital plans (including prudential indicators);
- the treasury management strategy (how the investments and borrowings are to be organised) including treasury indicators; and
- an investment strategy (the parameters on how investments are to be managed).

A mid year treasury management report – This will update members with the progress of the capital position, amending prudential indicators as necessary, and whether any policies require revision.

An annual treasury report – This provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.

Scrutiny
The above reports are required to be adequately scrutinised before being recommended to the Council. This role is undertaken by the Policy and Resources Committee.

Capital Strategy
In December 2017, CIPFA issued revised Prudential and Treasury Management Codes. As from 2019-20, all local authorities will be required to prepare an additional report, a Capital Strategy report, which is intended to provide the following:

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

The aim of this report is to ensure that all elected members on the full council fully understand the overall strategy, governance procedures and risk appetite entailed by this Strategy.

The Capital Strategy will include capital expenditure, investments and liabilities and treasury management in sufficient detail to allow all members to understand how stewardship, value for money, prudence, sustainability and affordability will be secured.

1.4 Treasury Management Strategy for 2018/19
The strategy for 2018/19 covers two main areas:

Capital issues

- the capital plans and the prudential indicators..

Treasury management issues

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

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

1.5 Training
The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsible for scrutiny. Training was undertaken by members as part of the 2017 Member Induction Programme and further training will be arranged as required.

The training needs of treasury management officers are periodically reviewed.

1.6 Treasury Management Consultants
The Council uses Link Asset Services (previously part of Capita Asset Services) as its external treasury management advisors.

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

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

2.0 Capital Prudential Indicators 2018/19 to 2020/21

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

2.1 Capital Expenditure
This prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle. The Capital Plan for 2018/19 to 2027/28 includes the following capital expenditure forecasts for the first three years. 2016/17 actual and 2017/18 projected figures are also shown below:

	Actual	Projected	Estimate		
Capital Expenditure	**2016/17 £m**	**2017/18 £m**	**2018/19 £m**	**2019/20 £m**	**2020/21 £m**
Priority Projects	25.546	48.137	23.151	10.359	14.295
Asset classes	24.645	26.873	25.073	24.110	22.735
Total as per Capital Investment Strategy	**50.191**	**75.010**	**48.224**	**34.469**	**37.030**

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 funding borrowing need.

	Actual	Projected	Estimate		
	2016/17 £m	**2017/18 £m**	**2018/19 £m**	**2019/20 £m**	**2020/21 £m**
Capital Expenditure	**50.191**	**75.010**	**48.224**	**34.469**	**37.030**
Financed by:					
Scottish Govt Capital Grant	15.651	23.061	20.430	25.394	23.928
Capital Receipt	0.500	0.500	0.500	0.500	0.500
Capital Fund	3.509	5.989	0.876	0.000	0.000
Loan Charges Released	1.478	0.753	(1.064)	(1.542)	(0.840)
Net Capital Expenditure	**29.053**	**44.707**	**27.482**	**10.117**	**13.442**
Other Expenditure (Spend to Save)	2.590	1.997	1.631	0.000	0.000
Net Financing Need for Year	**31.643**	**46.704**	**29.113**	**10.117**	**13.442**

2.2 The Council's Borrowing Need (the Capital Financing Requirement)

The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. Any capital expenditure above, which has not immediately been paid for, 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 pool charges), or another suitable method of calculation in order to repay borrowing.

The CFR includes any other long term liabilities (OLTL) (e.g. PFI schemes, finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes. The Council currently has £108m of such schemes within the CFR.

The Council is asked to approve the CFR projections below:

	Actual	Projected	Estimate		
	2016/17 £m	**2017/18 £m**	**2018/19 £m**	**2019/20 £m**	**2020/21 £m**
Capital Financing Requirement					
CFR exc OLTL	274.570	306.024	320.099	314.836	313.140
OLTL	107.940	105.394	102.762	100.250	97.834
Total CFR	**382.510**	**411.418**	**422.861**	**415.086**	**410.974**
Movement in CFR		**28.908**	**11.443**	**(7.775)**	**(4.112)**

	Actual	Projected	Estimate		
	2016/17 £m	**2017/18 £m**	**2018/19 £m**	**2019/20 £m**	**2020/21 £m**
Net financing need for the year (2.1 above)		46.704	29.113	10.117	13.442
Less scheduled debt amortisation		15.251	15.037	15.380	15.138
Less payment to OLTL		2.545	2.633	2.512	2.416
Movement in CFR		**28.908**	**11.443**	**(7.775)**	**(4.112)**

As at 1 April 2017 £274.570m still requires to be charged to the revenue account. The redemption profile for this is shown on Annex 1.

3.0 Borrowing

The capital expenditure plans set out in Section 2 provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the 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 approporiate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

3.1 Current Portfolio Position

The Council's treasury portfolio position at 31 March 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.

	Actual	Projected	Estimate		
Capital Financing Requirement	**2016/17 £m**	**2017/18 £m**	**2018/19 £m**	**2019/20 £m**	**2020/21 £m**
External Debt					
Debt at 1 April	194.593	205.783	243.345	260.797	258.377
Expected change in Debt	11.190	37.562	17.452	(2.420)	905
OLTL at 1 April	110.374	107.940	105.394	102.762	100.250
Expected change in OLTL	(2.434)	(2.546)	(2.632)	(2.512)	(2.416)
Actual gross debt at 31 March	**313.723**	**348.739**	**363.559**	**358.627**	**357.116**
The Capital Financing Requirement	**382.510**	**411.418**	**422.861**	**415.086**	**410.974**
Under (over) borrowing	**68.787**	**62.679**	**59.302**	**56.459**	**53.858**

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 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 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 Council has complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in the Financial Plans for 2018/19.

3.2 Treasury Indicators: Limits to Borrowing Activity

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

	Actual	Projected	Estimate		
Operational boundary	**2016/17 £m**	**2017/18 £m**	**2018/19 £m**	**2019/20 £m**	**2020/21 £m**
Debt	230.783	270.512	288.837	286.296	287.246
Other long term liabilities	107.940	105.394	102.762	100.250	97.834
Total	338.723	375.906	391.599	386.546	385.080

The authorised limit for external debt. 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 debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

a) 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.

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

	Actual	Projected	Estimate		
Authorised limit	**2016/17 £m**	**2017/18 £m**	**2018/19 £m**	**2019/20 £m**	**2020/21 £m**
Debt	318.096	350.319	355.721	359.539	364.127
Other long term liabilities	107.940	105.394	102.762	100.250	97.834
Total	426.036	455.713	458.483	459.789	461.961

3.3 Prospects for Interest Rates (as provided by Link Asset Services, February 2018)

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

	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank rate	0.50%	0.75%	0.75%	1.00%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.50%
5yr PWLB rate	1.90%	2.00%	2.10%	2.10%	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%
10yr PWLB rate	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%
25yr PWLB rate	2.80%	2.90%	3.00%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB rate	2.60%	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%

The Monetary Policy Committee (MPC) delivered a 0.25% increase in Bank Rate at its meeting on 2 November 2017. 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 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.

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 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 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 selloff in equities and bonds in February 2018 that has given further impetus to a rise in bond yields.

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.

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, emerging market developments and sharp changes in investor sentiment. Such volatility could occur at any time during the forecast period.

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.

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.

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 a fully agreed and stable coalition 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

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

- 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.

- 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, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

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 have been volatile so far in 2017-18 and increased sharply after the result of the general election in June 2017, after the September MPC meeting, (when financial markets reacted by accelerating their expectations for the timing of Bank Rate increases), and again in January and February 2018. Increases have ben sharper in periods up to 10 years than in longer maturities.. 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 authorities 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.

3.4 Borrowing Strategy

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

Against this background and the risks within the economic forecast, caution will be adopted with the 2018/19 treasury operations. The Head of Finance 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 sharp FALL in long and short term rates* (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.

- *if it 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. Most likely, fixed rate funding will be drawn whilst interest rates are lower than they are projected to be in the next few years.

Any decisions will be reported to the Policy and Resources Committee at the next available opportunity.

3.5 Policy on Borrowing in Advance of Need

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

3.6 Debt Rescheduling

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

The reasons for any rescheduling to take place will include:

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

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

All rescheduling will be reported to the Policy and Resources Committee at the earliest meeting following its action

4.0 Annual Investment Strategy

4.1 Investment Policy

The Council's investment policy has regard to the Scottish Government's Investments Investment (Scotland) Regulations, (and accompanying Finance Circular), and the CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2017, ("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 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 listed in appendices 5.4 and 5.5. Counterparty limits will be as set through the Council's treasury management practices – schedules.

4.2 Creditworthiness Policy

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

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

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

The Link Asset Services' creditworthiness service uses a wider array of information than just primary ratings. Furthermore, by using a risk weighted scoring system, it 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 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 Link Asset Services. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

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

4.3 Country and Sector Considerations

a) All investments will be with UK institutions.
b) 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.
c) Although not currently used, the Council may consider the use in the future of the UK Government including in the form of gilts and the Debt Management Account Deposit Facility (DMADF), as well as Money Market Funds. Members' approval will be sought before investments are placed with these institutions.

4.4 Institutional Limits

a) At the Policy and Resources Committee on 16 November 2017 Members agreed a proposal in The Treasury Management Mid-Year Review 2017/18 that the counterparty limit with the Council's bank (Bank of Scotland) be increased from £20M to £25M for a 6 month period.
b) Following an assessment by the Head of Finance it is proposed that the increased counterparty limit of £25M with the Bank of Scotland be made permanent. This will allow the Council to continue to operate normal current account banking and overnight facilities as well as short-term investment opportunities. This limit will be kept under continual review
c) General institutional investment limits are as follows
    - Bank of Scotland £25M (assuming approval of 4.4(b) above)
    - Other UK Banks £10M
    - UK Local Authorities £5M
    - UK Building Societies £5M

Limits applied to individual counterparties will be detailed within the Council's Treasury Management Practices – Schedules

4.5 Investment Strategy

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

Investment returns expectations.
Bank Rate is forecast to increase in May and November 2018 moving to 1.00%, then rising in November 2019 to 1.25% and finally seeing a rise in August 2020 taking the rate to 1.50%. Bank Rate forecasts for financial year ends (March) are:

- 2017/18 0.50%
- 2018/19 1.00%
- 2019/20 1.25%
- 2020/21 1.50%

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

2017/18	0.40%
2018/19	0.80%
2019/20	1.25%
2020/21	1.50%

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

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

4.6 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

5.0 Appendices

5.1 The Capital Prudential and Treasury Indicators 2018/19 – 2020/21

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

5.1.1 Capital Expenditure

Capital expenditure plans for the period 2018/19 to 2020/21 included in the Capital Investment Strategy agreed by Full Council on 27 February 2018 are as follows:

	Actual	**Projected**	**Estimate**		
Capital Expenditure	**2016/17 £m**	**2017/18 £m**	**2018/19 £m**	**2019/20 £m**	**2020/21 £m**
Priority Projects	25.546	48.137	23.151	10.359	14.295
Asset classes	24.645	26.873	25.073	24.110	22.735
Total as per Capital Investment Strategy	**50.191**	**75.010**	**48.224**	**34.469**	**37.030**

5.1.2 Statutory repayment of loans fund advances

Under Finance Circular 7/2016 and following the introduction of 'The Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016 – Loans Fund Accounting' 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.

Option 1- Statutory method
Loans fund advances will be repaid 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;

Option 2 - Depreciation method
Annual repayment of loans fund advances will follow standard depreciation accounting procedures;

Option 3 - Asset life method
Loans fund advances will be repaid with reference to the life of an asset using either the equal instalment or annuity method;

Option 4 - Funding/ Income profile method
Loans fund advances will be repaid by reference to an associated income stream.

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 1), 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** – loans fund advances will be repaid with reference to the life of an asset using the annuity method (option 3).

The annuity rate applied to the loans fund repayments was based on historic interest rates and for advances prior to 1 April 2016 was 8%. However, under regulation 14 (2) of SSI 2016 No 123, the Head of Finance has reviewed and re-assessed the historic annuity rate to ensure that it is a prudent application. The result of this review suggests that a revised annuity rate of 5% would provide a fairer and more prudent approach and provide principal repayments more closely associated with the use of the assets, and Members are recommended to approve the revised rate.

5.1.3 Affordability prudential indicators

The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. The Council is asked to approve the following indicator:

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.

%	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
Excluding OLTL	6.6%	6.6%	6.9%	7.3%	7.5%
Including OLTL	7.3%	7.4%	7.6%	8.0%	8.3%

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

5.1.4 Maturity structure of borrowing

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

The Council is asked to approve the following treasury indicators and limits:

Maturity Structure of Long Term Debt 2018/19			
	Lower	**Upper**	**Current Actual**
Under 12 months	0%	20%	3.25%
12 months to 2 years	0%	20%	4.09%
2 years to 5 years	0%	25%	7.74%
5 years to 10 years	0%	25%	12.63%
10 years and above	50%	100%	72.29%

Limit on Temporary Debt (Under 12 months) 2018/19 (as percentage of total external debt)			
	Lower	**Upper**	**Current Actual**
Under 12 months	0%	25%	19.76%

Current external debt totals £239.847m. The maturity profile of this debt is as follows, and is shown in Annex 2.

Maturity Profile of Long Term Debt 2018/19		
	2016/17 Actual £m	**Current Actual £m**
Under 1 Year	7.977	6.250
1 to 2 Years	6.250	7.854
2 to 5 Years	2.055	14.888
5 to 10 Years	31.961	24.279
10 to 15 Years	0.720	0.715
15 to 20 Years	0.681	0.681
20 to 25 Years	0.703	0.703
25 to 30 Years	6.643	7.346
30 to 35 Years	18.462	22.539
35 to 40 Years	40.209	39.014
40 to 45 Years	20.563	16.978
45 to 50 Years	25.000	44.000
Over 50 Years	7.000	7.000
Total Long-Term Debt	**168.224**	**192.247**
Temporary Debt	37.559	47.600
Total External Debt	**205.783**	**239.847**

The average duration to maturity on this debt is 32.2 years.

5.1.5. Control of interest rate exposure

Limits on interest rate exposure 2018/19			
	Lower	**Upper**	**Current Actual**
Fixed Rate Exposure	70%	100%	82.8%
Variable Rate Exposure	0%	30%	17.2%

5.2 Interest Rate Forecasts 2018 – 2021

PWLB rates and forecast shown below have taken into account the 20 basis point certainty rate reduction effective as of the 1st November 2012.

Link Asset Services Interest Rate View	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate View	0.50%	0.75%	0.75%	1.00%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.50%
3 Month LIBID	0.40%	0.70%	0.70%	0.90%	0.90%	0.90%	0.90%	1.20%	1.20%	1.20%	1.40%	1.40%	1.40%
6 Month LIBID	0.50%	0.80%	0.80%	1.00%	1.00%	1.00%	1.10%	1.30%	1.30%	1.40%	1.50%	1.50%	1.50%
12 Month LIBID	0.80%	1.10%	1.10%	1.20%	1.20%	1.20%	1.30%	1.40%	1.40%	1.50%	1.70%	1.70%	1.70%
5yr PWLB Rate	1.90%	2.00%	2.10%	2.10%	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%
10yr PWLB Rate	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%
25yr PWLB Rate	2.80%	2.90%	3.00%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB Rate	2.60%	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%
Bank Rate													
Link Asset Services	0.50%	0.75%	0.75%	1.00%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.50%
Capital Economics	0.50%	0.75%	1.00%	1.25%	1.25%	1.50%	1.50%	1.75%	2.00%	2.00%	2.25%	2.25%	0.00%
5yr PWLB Rate													
Link Asset Services	1.90%	2.00%	2.10%	2.10%	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%
Capital Economics	1.70%	1.90%	2.10%	2.40%	2.40%	2.40%	2.40%	2.40%	2.40%	2.65%	2.65%	2.90%	0.80%
10yr PWLB Rate													
Link Asset Services	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%
Capital Economics	2.20%	2.40%	2.60%	2.80%	2.80%	2.80%	2.80%	2.80%	2.80%	3.05%	3.05%	3.30%	0.80%
25yr PWLB Rate													
Link Asset Services	2.80%	2.90%	3.00%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%	3.60%	3.60%
Capital Economics	2.60%	2.90%	3.10%	3.30%	3.30%	3.30%	3.35%	3.35%	3.35%	3.60%	3.60%	3.80%	0.80%
50yr PWLB Rate													
Link Asset Services	2.60%	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%
Capital Economics	2.50%	2.70%	2.90%	2.90%	2.90%	3.05%	3.05%	3.15%	3.15%	3.40%	3.40%	3.65%	0.80%

As supplied by Link Asset Services February 2018

5.3 Economic Background (as provided by Link Asset Services, February 2018)

GLOBAL OUTLOOK. World growth looks to be on an encouraging trend of stronger performance, rising earnings and falling levels of unemployment. In October 2017, the IMF upgraded its forecast for world growth from 3.2% to 3.6% for 2017 and 3.7% for 2018.

In addition, inflation prospects are generally muted in the major western economies and it is particularly notable that wage inflation has also been subdued despite unemployment falling to historically very low levels in the UK and US, (though increases in wage rates in the US have started recently to cause the Fed more concern) . This has led to many comments by economists that there appears to have been a fundamental shift downwards in the Phillips curve (this plots the correlation between levels of unemployment and inflation e.g. if the former is low the latter tends to be high). In turn, this raises the question of what has caused this? The likely answers probably lay in a combination of a shift towards flexible working, self-employment, falling union membership and a consequent reduction in union power and influence in the economy, and increasing globalisation and specialisation of individual countries, which has meant that labour in one country is in competition with labour in other countries which may be offering lower wage rates, increased productivity or a combination of the two. In addition, technology is probably also exerting downward pressure on wage rates and this is likely to grow with an accelerating movement towards automation, robots and artificial intelligence, leading to many repetitive tasks being taken over by machines or computers. Indeed, this is now being labelled as being the start of the fourth industrial revolution.

KEY RISKS - central bank monetary policy measures
Looking back on nearly ten years since the financial crash of 2008 when liquidity suddenly dried up in financial markets, it can be assessed that central banks' monetary policy measures to counter the sharp world recession were successful. The key monetary policy measures they used were a combination of lowering central interest rates and flooding financial markets with liquidity, particularly through unconventional means such as Quantitative Easing (QE), where central banks bought large amounts of central government debt and smaller sums of other debt.

The key issue now is that that period of stimulating economic recovery and warding off the threat of deflation is coming towards its close and a new period has already started in the US, and more recently in the UK, on reversing those measures i.e. by raising central rates and (for the US) reducing central banks' holdings of government and other debt. These measures are now required in order to stop the trend of an on-going reduction in spare capacity in the economy, and of unemployment falling to such low levels that the re-emergence of inflation is viewed as a major risk. It is, therefore, crucial that central banks get their timing right and do not cause shocks to market expectations that could destabilise financial markets. In particular, a key risk is that because QE-driven purchases of bonds drove up the price of government debt, and therefore caused a sharp drop in income yields, this then also encouraged investors into a search for yield and into investing in riskier assets such as equities. This resulted in bond markets and equity market prices both rising to historically high valuation levels simultaneously. This, therefore, makes both asset categories vulnerable to a sharp correction. It is important, therefore, that central banks only gradually unwind their holdings of bonds in order to prevent destabilising the financial markets. It is also likely that the timeframe for central banks unwinding their holdings of QE debt purchases will be over several years. They need to balance their timing to neither squash economic recovery by taking too rapid and too strong action, or, alternatively, let inflation run away by taking action that was too slow and/or too weak. The potential for central banks to get this timing and strength of action wrong are now key risks.

There is also a potential key question over whether economic growth has become too dependent on strong central bank stimulus and whether it will maintain its momentum against a backdrop of rising interest rates and the reversal of QE. In the UK, a key vulnerability is the low level of productivity growth, which may be the main driver for increases in wages; and decreasing consumer disposable income, which is important in the context of consumer expenditure primarily underpinning UK GDP growth.

A further question that has come to the fore is whether an inflation target for central banks of 2%, is now realistic given the shift down in inflation pressures from internally generated inflation, (i.e. wage inflation feeding through into the national economy), given the above mentioned shift down in the Phillips curve.

- Some economists favour a shift to a lower inflation target of 1% to emphasise the need to keep the lid on inflation. Alternatively, it is possible that a central bank could simply 'look through' tepid wage inflation, (i.e. ignore the overall 2% inflation target), in order to take action in raising rates sooner than might otherwise be expected.
- However, other economists would argue for a shift *UP* in the inflation target to 3% in order to ensure that central banks place the emphasis on maintaining economic growth through adopting a slower pace of withdrawal of stimulus.
- In addition, there is a strong argument that central banks should target financial market stability. As mentioned previously, bond markets and equity markets could be vulnerable to a sharp correction. There has been much commentary, that since 2008, QE has caused massive distortions, imbalances and bubbles in asset prices, both financial and non-financial. Consequently, there are widespread concerns at the potential for such bubbles to be burst by exuberant central bank action. On the other hand, too slow or weak action would allow these imbalances and distortions to continue or to even inflate them further.
- Consumer debt levels are also at historically high levels due to the prolonged period of low cost of borrowing since the financial crash. In turn, this cheap borrowing has meant that other non-financial asset prices, particularly house prices, have been driven up to very high levels, especially compared to income levels. Any sharp downturn in the availability of credit, or increase in the cost of credit, could potentially destabilise the housing market and generate a sharp downturn in house prices. This could then have a destabilising effect on consumer confidence, consumer expenditure and GDP growth. However, no central bank would accept that it ought to have responsibility for specifically targeting house prices.

UK. After the UK surprised on the upside with strong economic growth in 2016, growth in 2017 has confounded pessimistic forecasts of weak growth by coming in at 1.8%, only marginally down on the 1.9% rate for 2016. In 2017, quarter 1 came in at only +0.3%

(+1.8% y/y), quarter 2 +0.3% (+1.5% y/y), quarter 3 +0.4% (+1.5% y/y) and Q4 was +0.5% (+1.5% y/y). The outstanding performance came from the manufacturing sector which showed a 1.3% increase in Q4 and +3.1% y/y helped by an increase in exports due to the lower value of sterling over the last year and robust economic growth in our main trade partners, the EU and US. It is also notable that there has been a progressive acceleration in total GDP growth during the year which gives ground for optimism looking forward into 2018.

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. Inflation fell to 3.0% in December and January.) 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 was, therefore, not quite the 'one and done' scenario but was, 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.

The 8 February 2018 MPC meeting did not change Bank Rate but the forward guidance changed significantly to warn of "earlier, and greater than anticipated" rate of increases in Bank compared to their previous forward guidance. The Link Asset Services forecast has therefore added an additional 0.25% increase in Bank Rate in May 2018 compared to the previous forecast, and then increases occurring November 2018, November 2019 and August 2020 to end at 1.50%

However, some forecasters are flagging up that they expect growth to accelerate significantly in 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 further 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.

EZ. 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 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 quarter 1 (2.1% y/y), 0.7% in quarter 2 (2.4% y/y), +0.7% in quarter 3 (2.8% y/y) and quarter 4 +0.6% (2.7%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 December inflation was 1.4%. 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 started erratically with quarter 1 coming in at an annualised rate of only 1.2%, quarter 2 at 2.3%, quarter 3 3.1% and quarter 4 2.6% This gave an overall figure for annual growth in 2017 of 2.6%, an acceleration from 1.5% in 2016. Unemployment in the US has also fallen to the lowest level for seventeen 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 five 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, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

JAPAN. GDP growth has been gradually improving during 2017 to reach an annual figure of 2.1% in quarter 3. 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.

<u>Brexit timetable and process</u>

- 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.

5.4 Treasury Management Practice (TMP1): Permitted Investments And Associated Risk

Permitted Investments

This Council approves the following forms of investment instrument for use as permitted investments.

1. Treasury Investments

1.1 Deposits

	Minimum Credit Criteria	Liquidity risk	Market risk	Maximum investment	Max. maturity period
Debt Management Agency Deposit Facility	n/a	term	no		3 months
Term deposits – local authorities	n/a	term	no	£5,000,000	3 months
Term accounts – banks and building societies	Link colour rating green	term	no	£10,000,000	3 months
Call deposits – banks and building societies	Link colour rating green	instant	no	£15,000,000	3 months

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.

b) **Term deposits with high credit worthiness banks and building societies**. This is the most widely used form of investing used by local authorities. It offers a higher rate of return than the DMADF (dependent on term) and now that measures have been put in place to avoid over reliance on credit ratings, the authority feels much more confident that the residual risks around using such banks and building societies are at a low, reasonable and acceptable level. 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 1.1 b. 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.

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

	Minimum Credit Criteria	Liquidity risk	Market risk	Maximum investment	Max. maturity period
Term accounts - UK nationalised banks	Link colour rating blue	term	no	£20,000,000	3 months
Call deposits - UK nationalised banks	Link colour rating blue	instant	no	£20,000,000	3 months

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

a) **Term deposits with high credit worthiness banks which are fully or semi nationalised.** As for 1.1 b. but Government ownership partial or full implies that the Government stands behind this bank and will be deeply committed to providing whatever support that may be required to ensure the continuity of that bank. This authority considers this indicates a low and acceptable level of residual risk.

b) **Call accounts with high credit worthiness banks which are fully or semi nationalised.** As for 1.1 c. but Government ownership partial or full implies that the Government stands behind this bank and will be deeply committed to providing whatever support that may be required to ensure the continuity of that bank. This authority considers this indicates a low and acceptable level of residual risk.

2. Treasury Risks

All the investment instruments in the above tables are subject to the following risks: -

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

2. **Liquidity risk**: this is the risk that cash will not be available when it is needed. While it could be said that all counterparties are subject to at least a very small level of liquidity risk as credit risk can never be zero, in this document, liquidity risk has been treated as whether or not instant access to cash can be obtained from each form of investment instrument. The column in the tables above headed as 'liquidity risk' will show each investment instrument as being instant access, or term i.e. money is locked in until an agreed maturity date.

3. **Market risk**: this is the risk that, through adverse market fluctuations in the value of the principal sums an organisation borrows and invests, its stated treasury management policies and objectives are compromised, against which effects it has failed to protect itself adequately.

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

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

3. Controls on Treasury Risks

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

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

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

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

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

4 Permitted Investments, Associated Controls and Limits

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits
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 3 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.	£5m and maximum 3 months.
c. 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) and (b) above. Whilst there is no risk to value with these types of investments, liquidity is high and investments can be returned at short notice.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's day to day investment dealing with this criteria will be further strengthened by use of additional market intelligence.	£25m. (Individual counterparty limits per Treasury Management Practices – Schedules)
d. 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) and (b) above. Whilst there is no risk to value with these types of investments, liquidity is low and term deposits can only be broken with the agreement of the counterparty, and penalties may apply.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's. Day to day investment dealing with this criteria will be further strengthened by use of additional market intelligence.	£25m and maximum 3 months. (Individual counterparty limits per Treasury Management Practices – Schedules)

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

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

	Minimum Credit Criteria	Liquidity risk	Market risk	Maximum investment	Max. maturity period
Cash deposits – local authorities, banks, building societies and cash funds	Relevant parameters as per specific investment mandates and/or specific trust deeds	term	yes	Relevant parameters as per specific investment mandates and/or specific trust deeds.	
Equities – UK and Overseas		term	yes		
Fixed Income, Index Linked Bonds, Unit Trusts		term	yes		
War Stock		term	no		
Alternative Investments - Property		term	yes		

6. Non Treasury Investments
Definition of Non Treasury Investments

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

a) All share holding, unit holding and bond holding, including those in a local authority owned company, is an investment
b) Loans to a local authority company or other entity formed by a local authority to deliver services, is an investment.
c) Loans made to third parties are investments.
d) Investment property is an investment.

6.1 Investments

<table>
<tr><th></th><th>Minimum Credit Criteria</th><th>Liquidity risk</th><th>Market risk</th><th>Maximum investment</th><th>Max. maturity period</th></tr>
<tr><td>Loans to Companies, including Local Authority owned.</td><td rowspan="5">See Regulation Notes below</td><td>term</td><td>no</td><td rowspan="5" colspan="2">See Regulation requirements and current approvals below.</td></tr>
<tr><td>Shares and Bonds in Companies, including Local Authority owned.</td><td>term</td><td>no</td></tr>
<tr><td>Loans to Third Parties including investments in sub-ordinated debt (see note 1 below).</td><td>instant</td><td>no</td></tr>
<tr><td>Local Authority Investment Properties.</td><td>term</td><td>no</td></tr>
<tr><td>Other Investment Deposits</td><td>term</td><td>no</td></tr>
</table>

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

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

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

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

Current Approvals
Note 1 – Subordinated Debt – At the Policy and Resources Committee on 17 February 2015, Members agreed that the Council's investment strategy be amended to permit subordinated debt investments in Sub HubCo projects. The maximum duration of investments was extended to 30 years at the Policy and Resources Committee on 14 January 2016. Current investments total £209,082 out of a maximum of £800,000.

Note 2 – Equity Investment – At the Policy and Resources Committee on 14 January 2016, Members agreed that the Council's investment strategy be amended to permit a 10 percent equity stake in the Design, Build, Maintain and Finance (DBFM) Holding Company set up for the Dalbeattie Learning Campus Project with a cost/exposure of 10p (10 pence).

5.5 Scheme Of Delegation

5.5.1 The Council shall;

- receive and review reports on treasury management policies, practices and activities, and
- approve the annual strategy.

5.5.2 The Council's Policy and Resources Committee shall;

- approve / amend the organisation's adopted clauses, treasury management policy statement and treasury management practices;
- consider and approve budget;
- approve the division of responsibilities;
- receive and review regular monitoring reports and act on recommendations;
- approve the selection of external service providers and agree terms of appointment.

5.5.3 The Section 95 Officer shall;

- review the treasury management policy and procedures and make recommendations to the responsible body.

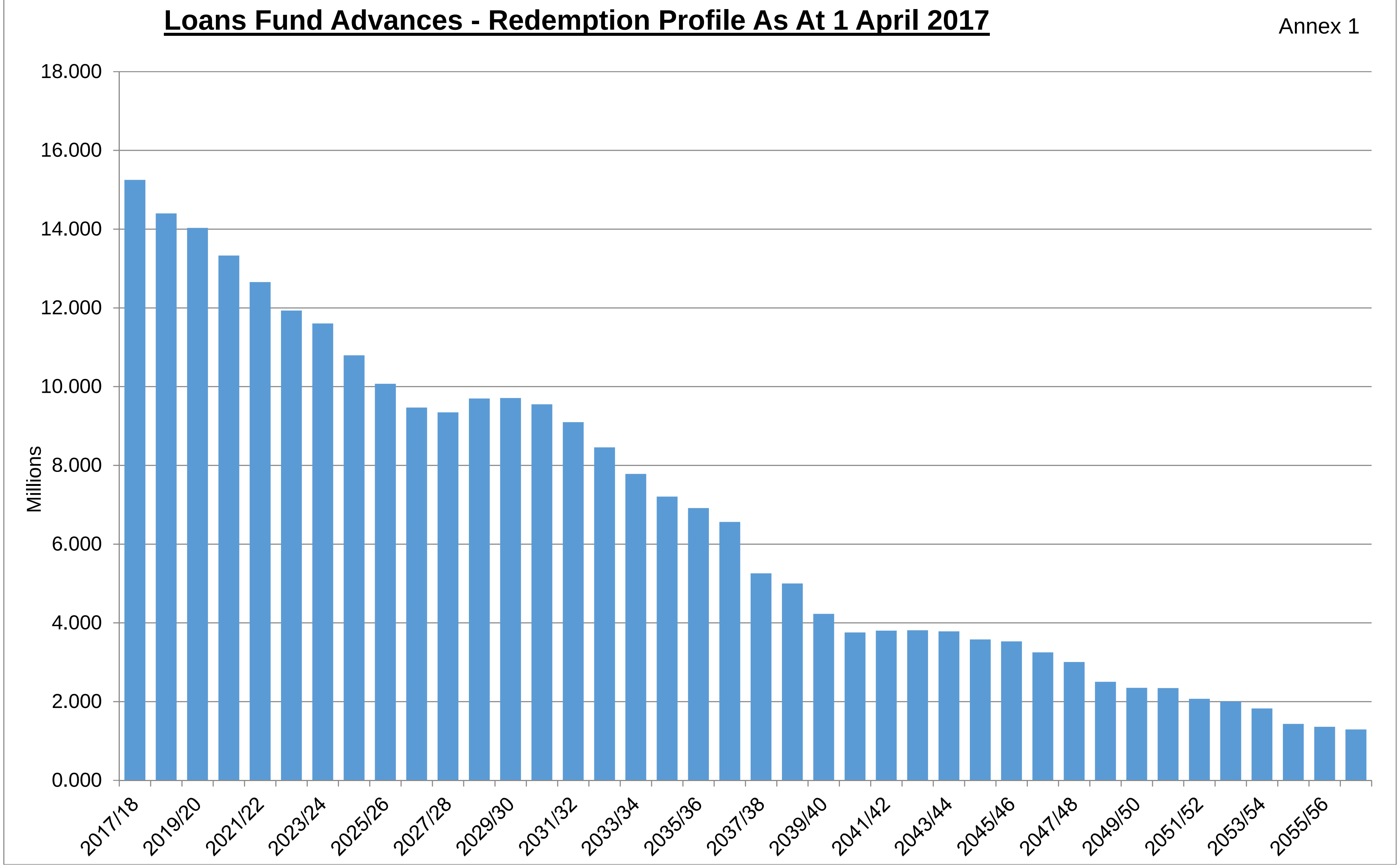
5.6 The Treasury Management Role of the Section 95 Officer

The S95 (responsible) officer is required to:

- recommend clauses, treasury management policy/practices for approval, review the same regularly, and monitor compliance;
- submit regular treasury management policy reports;
- submit budgets and budget variations;
- receive and review management information reports;
- review the performance of the treasury management function;
- ensure the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function;
- ensure the adequacy of internal audit, and liaising with external audit;
- recommend the appointment of external service providers.
- ensure that the authority has adequate expertise, either in house or externally provided, to carry out the above

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

Annex 1



Loans Fund Advances - Redemption Profile As At 1 April 2017
Millions
18.000
16.000
14.000
12.000
10.000
8.000
6.000
4.000
2.000
0.000
2017/18
2019/20
2021/22
2023/24
2025/26
2027/28
2029/30
2031/32
2033/34
2035/36
2037/38
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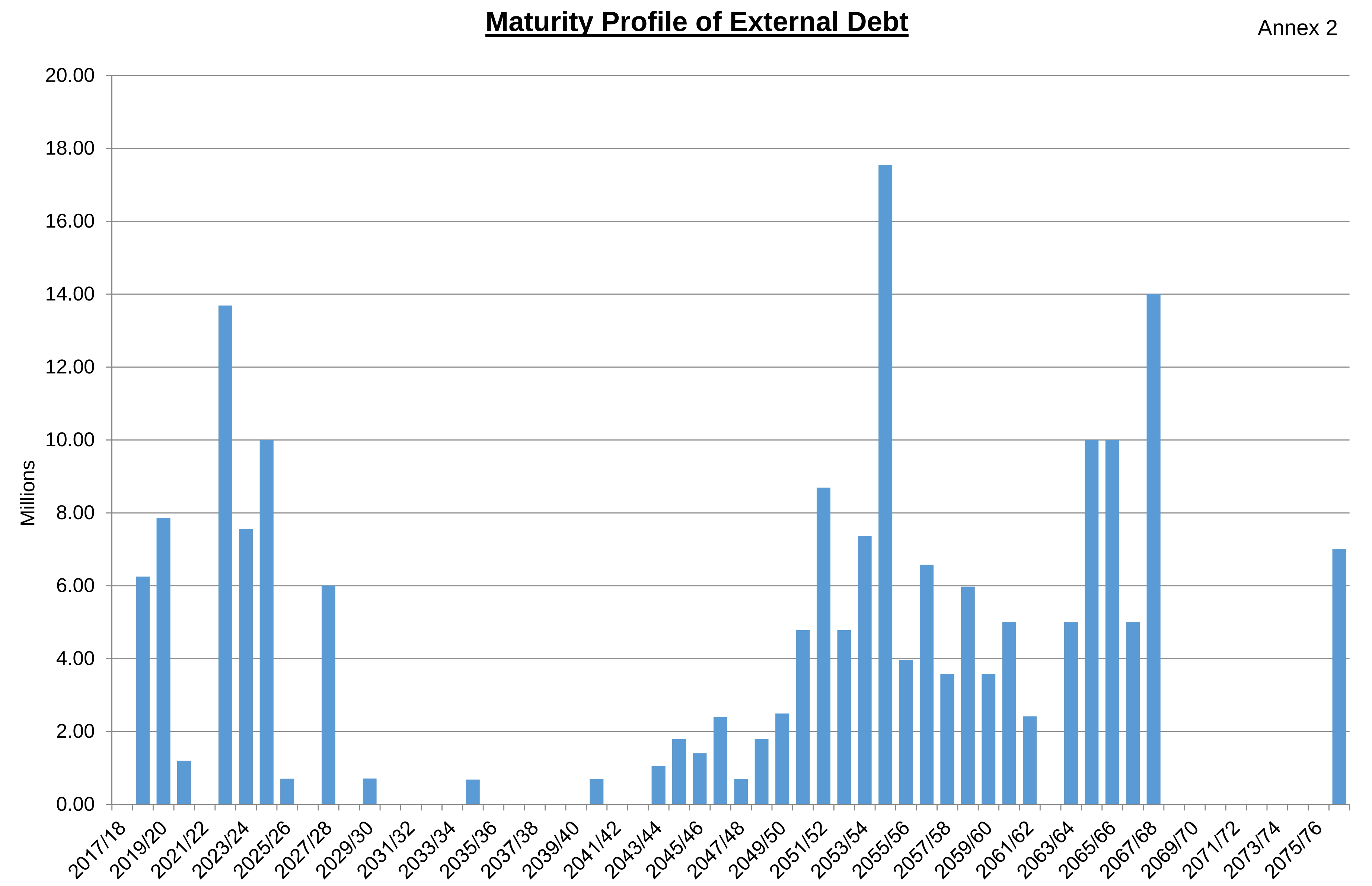
2049/50
2051/52
2053/54
2055/56

Annex 2



Maturity Profile of External Debt
Millions
20.00
18.00
16.00
14.00
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4.00
2.00
0.00
2017/18
2019/20
2021/22
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