PERTH AND KINROSS COUNCIL

20 June 2018

ANNUAL TREASURY REPORT 2017/18

Report by Head of Finance (Report No. 18/211)

PURPOSE OF REPORT

This report summarises the Council's treasury activities for the 2017/18 financial year and compares actual performance with the approved Treasury and Investment Strategy for 2017/18.

1. BACKGROUND / MAIN ISSUES

1.1 A requirement of the Council's approved Treasury Management Practice 6 (TMP6 – Reporting Requirements & Management Information Arrangements) is the reporting to the Council of the expected treasury activity for the forthcoming year (i.e. the Treasury and Investment Strategy) and the subsequent reporting of the actual results and activities (i.e. this Annual Treasury Report). The Council meeting on 22 February 2017 approved the Treasury Strategy for the 6 financial years 2017/18 to 2022/23 and the annual Investment Strategy for 2017/18 (Report No. 17/81 refers).

1.2 This Annual Treasury Report covers:

- The Council's treasury position
- The forecast economic outlook and borrowing strategy for 2017/18
- The actual economic situation for 2017/18
- Actual long term borrowing and repayments in 2017/18
- The Statutory Loans Fund position
- The Investment Strategy and outturn for 2017/18
- Compliance with treasury policies and limits during 2017/18

2. THE TREASURY POSITION

2.1 In order to place this report in context, the Council's Treasury position at the beginning and at the end of the year is shown below:

	Principal Outstanding 31 Mar 2017 £M	Average Rate %	Principal Outstanding 31 Mar 2018 £M	Average Rate %
Fixed Rate/Long Term Funding				
• Public Works Loan Board (PWLB)	243.2	3.67	310.0	3.15
• Market & Local Authority Bonds	43.2	4.59	43.2	4.59
• Other Loans & Bonds*	0.5	0.00	0.5	0.00
	286.9	3.80	353.7	3.32
Variable Rate/Short Term Funding				
• Temporary Loans	1.5	0.21	2.5	0.17
• Internal Loans	2.3	0.77	2.3	0.51
	3.8	0.54	4.8	0.33
TOTAL DEBT	**290.7**	**3.75**	**358.5**	**3.28**
SHORT TERM INVESTMENTS	**53.7**	**0.51**	**37.6**	**0.73**
*Interest free loans from Salix and the Scottish Government				

3. THE FORECAST ECONOMIC OUTLOOK AND BORROWING STRATEGY 2017/18

3.1 Following a period of rising inflation and falling interest rates, the Council's Treasury strategy for 2017/18 was based on the view that the volatility in the global economy would continue, particularly in the aftermath of the "Brexit" vote and the economic uncertainties that arose from the decision for the UK to leave the EU. This made it difficult to forecast interest rates with any degree of certainty. The Bank of England's Monetary Policy Committee (MPC) cut the Bank base rate from 0.50% to 0.25% in August 2016, although any further change was not expected to be imminent. The forecast was that the first increase would be in 2019 after the Brexit negotiations had concluded, however if inflation remained high then the increase in the Bank base rate could be brought forward. Medium and longer term interest rates were expected to rise slowly throughout 2017/18 and future years and remain at a higher level than short term rates.

3.2 The effect on interest rates for the UK was, therefore, expected to be as follows:

- Short-Term Interest rates – it was anticipated that the Bank base rate would initially remain at its low level of 0.25% for most of 2017/18, with the chances of subsequent movement in either direction equally balanced. It was still expected that there would be steady increases in later years.
- Long-Term Interest Rates – it was anticipated that long term Public Works Loan Board (PWLB) rates for 10 years would slowly increase during 2017/18, reaching around 2.3% by the year end (March 2018). The 50 year rate was expected to reach around 2.80% by the end of the year.

3.3 The estimated capital borrowing for 2017/18 at the start of the year was £60M, with the new borrowing requirement over the remaining six year period of the Capital programme totalling £307.8M. This included refinancing of maturing debt over the 6 year period, and incorporated an estimate of the annual borrowing requirement to be carried-forward between years. This borrowing requirement reflected the Capital Budget approved by the Council in June 2016, and was significantly larger than in previous years. The borrowing requirement was also significant as the start of 2017/18 coincided with the period of low forecast interest rates, which were expected to steadily rise over the coming years.

3.4 Effective Treasury Management considers the longer-term position in order to minimise costs and risks in the Council's portfolio. This included consideration of borrowing for future year requirements earlier within the 6 year period, whilst rates were at their forecast low point, particularly if they started to rise quickly. This approach is consistent with the Prudential Code, but should be considered in conjunction with the assessment of the additional risks and potentially low returns from the resultant short-term increase in the level of investments.

3.5 Whilst the use of short term borrowing would initially be cheaper, the use of longer term borrowing would give rise to longer term savings and reduce the refinancing risk in later years. However, if rates stayed low, new borrowing could be delayed and short term borrowing used to meet immediate cashflow requirements.

3.6 The approved Treasury Strategy allowed for consideration of other market borrowing instruments where they offered favourable rates and terms. However, the associated risks due to their variable rate nature and their less flexible terms in comparison to the Public Works Loan Board would also need to be considered.

3.7 The Council has traditionally adopted a policy of minimising exposure to risk, thus favouring fixed longer term borrowing. However, it was acknowledged that there were several factors which could impact on interest rates over the year. Therefore, the Council sought to apply an approach of managing risk and monitoring interest rates on an ongoing basis with a view to reviewing this strategy should circumstances change.

4. ACTUAL ECONOMIC SITUATION 2017/18

4.1 2017/18 proved to be another unsettled year for the financial markets. Economic growth in the UK was around 0.4% per quarter over most of the year. At the same time, Consumer Price Index (CPI) inflation increased steadily from 2.3% at the start of the year to 3.1% in November 2017, before reducing and ended the year at 2.5% in March 2018. Unemployment levels remained fairly static throughout the year at around 4.3% to 4.4%, whilst average earnings remained below the rate of inflation throughout the year.

4.2 The most significant factor affecting the economic situation in the UK was the continuing uncertainty around the impact of "Brexit". However, global political tensions in America, North Korea, Russia and China also impacted the financial markets, resulting in ongoing volatility. Gilt yields increased early in the year due to anticipated increases in the Bank base rate. However, due to ongoing political uncertainties around North Korea, the yields subsequently drifted lower as investors sought safe-haven investments. By September 2017, due to increasing inflation, the MPC advised that an increase in the Bank base rate was imminent, thus causing yields to rise sharply again.

4.3 The MPC subsequently increased the Bank base rate to 0.50% in November 2017, and at the same time, also advised that subsequent increases would be gradual. This caused longer term rates to fall. However, by February, the MPC advised that future increases in the Bank base rate would be sooner than previously expected, causing yields to rise again, particularly for short to medium term periods. However, at the same time, political tensions with Russia and an American-China trade war restricted the increases, and resulted in longer dated yields falling during March 2018.

4.4 Consequently, the 1 year PWLB rate rose from 1.03% at the start of the year, to 1.67% at the end of the year. The 10 year rate followed a similar pattern, rising from 2.11% to 2.43%. However, the 50 year rate started the year at 2.54% rising to 2.59% in October and peaking at 2.64% in February, before falling sharply to 2.29% at the end of March. All PWLB fixed rates were lower than forecast in the original strategy.

4.5 Various PWLB Standard Rates for the year are shown graphically at Appendix I. It should be noted that the 20 and 30-year rates remained higher than the 50-year rate throughout the year, and thus the longer-dated 50 year rates offered particular value for borrowing. It was also noteworthy that the difference in 10 year and 50 year rates narrowed over the year, and with 50 year rates briefly falling below the 10 year rate in March 2018. This differential between 10 and 50 year rates gave rise to opportunities for debt rescheduling, as detailed in Section 5.5 below.

4.6 Investment deposit rates increased slightly in the second half of the year from a relatively low level. This reflected the increased Bank base rate during the year, as well as expectations of further increases in the Bank Rate in the near future. The average rate on the Council's investments at the start of the year was 0.51%, which increased to 0.73% at the end of the year.

5. ACTUAL LONG TERM BORROWING & REPAYMENTS

5.1 The actual treasury activities during 2017/18 are comprehensively detailed in the four quarterly Treasury reports previously submitted to the Council (Report No's 17/318, 17/412, 18/66 and 18/148 refer).

5.2 As noted in Section 3.3 above, before the start of the year, the Council estimated that new capital borrowing for 2017/18 would be £60M, and the actual borrowing requirement and strategy would be subject to review, for example if interest rates started to increase rapidly. This may have included borrowing of future year's requirements.

5.3 A total of £75M of new longer-term borrowing was undertaken over the course of the year from the PWLB at an average rate of 2.28% and for an average period of 44 ½ years. The increased borrowing arose as a result of some acceleration of the budget for major capital schemes commencing during the year. In addition, the amount of the borrowing requirement carried forward from 2017/18 to 2018/19 was less than originally assumed.

5.4 The Council's scheduled repayments to the PWLB during the year related to 2 maturing loans which had been borrowed for 7 and 8 years totalling £8M at an average interest rate of 2.86%. One further scheduled repayment instalment of £80,645 was made on the EIP (Equal Instalment of Principal) loan, prior to the loan been prematurely repaid later in the year.

5.5 There were two debt rescheduling exercises undertaken during 2017/18, as detailed in the quarterly reports (reports 17/412 and 18/148 refer). As a result, a total of £14.1M of PWLB debt at an average interest rate of 6.81% and with an average of 20 years remaining was prematurely repaid during the year. This debt was replaced with 2 new loans for 50 years totalling £14M at an average rate of 2.38%. As a result of these premature repayments, a total of £10M of premiums were incurred, however total net savings over the life of the loans amount to £3.67M (£2.98M at current value), after allowing for the amortisation of the premium.

5.6 The average PWLB debt portfolio rate for the Council reduced from 3.67% at the start of the year, to 3.15% for the total of £310M of PWLB debt held by the Council at 31 March 2018.

5.7 In addition, scheduled instalments totalling £56,890 of the Council's interest-free loan with Salix Finance were repaid during the year. Overall, the Council's total Fixed Rate borrowing increased by £66.8M to £353.7M, whilst the average rate reduced from 3.80% to 3.32%.

5.8 Short term variable funding at the year-end increased from £3.8M at 31 March 2017 to £4.8M at 31 March 2018. The increase mostly relates to an amount received during the year which is held by the Council under a Section 75 planning obligation. The total of internal loans for the Common Good and Charities remained broadly unchanged over the year.

5.9 As a result of the above strategy and actual treasury activities in the year, the Council's average Consolidated Loans Fund (CLF) interest rate reduced from 3.38% in 2016/17 to 3.19% in 2017/18 (based on applying statutory guidance). This decrease reflects the impact of borrowing at lower rates and the debt rescheduling exercises undertaken during the year.

5.10 A comparison of the Council's CLF rate over recent years with the average for other Scottish Local authorities is shown graphically at Appendix II. Whilst figures for the Scottish average will not be published for 2017/18 until the autumn, this graph shows that over time, this Council's average borrowing costs have reduced to a level significantly below the Scottish average. This equates to savings in Loan Charges of around £2.5M per annum on the Council's portfolio compared to the Scottish average.

6. STATUTORY LOANS FUND

6.1 The Loans Fund is an internal fund operated by the Council to manage:

- The write down (or "amortisation") of capital expenditure (capital advances) over the life of the various assets being funded by borrowing as part of the Council's Loan Charges, and
- To manage the external borrowing raised to finance the capital expenditure.

6.2 Whilst both these elements of the Loans Fund operate independently of each other, because they are based on the same capital plans of the Council, they will broadly be consistent to each other over the long term. However, significant differences may arise over the short-term. This may include, for example, delaying external borrowing, or borrowing in advance in light of prevailing interest rates, or where the Council has significant levels of Reserves.

6.3 Following a review of Loans Fund policies, on 20 December 2017 (report 17/414 refers) the Council approved the amortisation of capital expenditure (advances) for periods of up to 50 years in line with the asset useful lives. The Council also approved the continuation of the annuity method for the repayment of all capital advances. The Loans Fund regulations also allow for the repayment of Loans Fund advances to be deferred until the asset being funded is completed and operational.

6.4 It is also a requirement of the regulations that the outstanding amount of Loans Fund advances at the end of each financial year is reported as part of the annual report. The value of Loans Fund advances outstanding (subject to audit) at 31 March 2018 is £399,959,734 (subject to completion and audit of the Council's statutory accounts). This is made up as follows:

- Capital Advances outstanding 1 April 2017 - £338,039,062
- Add New capital Advances 2017/18 - £77,553,375
- Less Capital Advances repaid in the year - £15,632,703

6.5 The future repayment of these advances is summarised in the table below:

	Core Composite Programme	Prudential Borrowing	**Sub-Total: General Fund**	Housing Revenue Account	**TOTAL**
(£'000)					
Within 1 Year	9,232	3,269	**12,501**	4,356	**16,857**
Between 1 and 2 Years	9,915	3,029	**12,944**	4,263	**17,207**
Between 2 and 5 Years	30,354	6,956	**37,310**	12,181	**49,491**
Between 5 and 10 Years	48,755	7,752	**56,507**	20,199	**76,706**
Between 10 and 15 Years	42,528	7,698	**50,226**	15,960	**66,186**
Between 15 and 20 Years	32,418	7,287	**39,705**	10,617	**50,322**
Between 20 and 25 Years	28,172	4,107	**32,279**	11,548	**43,827**
More than 25 Years	60,841	2,908	**63,749**	15,615	**79,364**
TOTAL	**262,215**	**43,006**	**305,221**	**94,739**	**399,960**

6.6 Comparison of the capital advances above with the long term external debt shown in Section 2.1 shows that the Council is currently "under-borrowed" by around £46.2M, ie actual capital expenditure funded by borrowing is higher than the actual borrowing undertaken to date. This reflects the strategy adopted in recent years of utilising short term cash balances (which have arisen due to the levels of reserves held by the Council in the short term) before undertaking new borrowing. This strategy has reduced the risks and low returns associated with investments in recent years.

6.7 The last report to the Strategic Policy & Resources Committee on 18 April 2018 (report 18/134) approved adjustments to the General Fund Composite Capital Budget and Housing Investment Programmes. The amount of capital expenditure to be funded by borrowing (ie new Loans Fund advances) in each of the next 5 years as approved in April is as follows:

	Composite Programme	Housing Investment Programme	**TOTAL**
(£'000)			
2018/19	46,919	10,846	**57,765**
2019/20	40,889	4,828	**45,717**
2020/21	65,313	5,298	**70,611**
2021/22	77,105	4,492	**81,597**
2022/23	49,936	23,485	**73,421**
TOTAL	**280,162**	**48,949**	**329,111**

The Composite Capital Budget is on the agenda for this Council meeting, and therefore the above borrowing estimates are subject to revision.

6.8 All the above Loans Fund repayments have been included in the Loan Charge estimates within the approved Medium Term Financial Plan, and therefore remain affordable under the current Loan Charge Budget strategy. This includes estimates of new borrowing in the years beyond 2022/23.

7. INVESTMENT STRATEGY AND OUTURN 2017/18

7.1 Short term deposit rates remained at low levels throughout the year, however they did increase from November 2017 following the increase in the Bank of England base rate. The low deposit rates also reflected regulatory changes and funding requirements for banks, which make it less attractive for banks to hold short term cash deposits. Therefore, instant access and short term deposit rates remained low relative to the bank rate.

7.2 As a result of the Council's positive cashflow in the first half of the year, the level of investments steadily increased, largely in the form of fixed rate deposits. With longer-term borrowing being undertaken throughout the year and being required to meet ongoing capital expenditure, the new borrowing did not significantly impact the level of investments. Therefore, the level of investments over the course of the year generally reflected the Council's cashflow on a day to day basis. The level of investments reduced over the year, from £53.75M at 31 March 2017 to £37.59M at 31 March 2018.

7.3 For shorter investment periods, notice deposit accounts and money market funds held by the Council provided a higher return on investments than rates available on instant access and shorter term fixed deposits. These facilities also helped to meet daily cashflow requirements and keep within counterparty limits. However, towards the financial year-end there was an increase in shorter term lending rates in the inter-local authority market, and therefore some lending for shorter periods was undertaken during this period.

7.4 During the year, no investment was made for more than 12 months, and all investment activities were in line with the approved strategy for 2017/18. The average rate on investments outstanding at 31 March 2018 was 0.73% (0.51% at 31 March 2017). This increase in the average rate over the year reflected the increase in the Bank base rate and the local authority lending rates. In comparison, the average temporary borrowing rate for the year was 0.20%. Total interest received on investments in 2017/18 amounted to £278,595 (£421,046 in 2016/17). This reflected the reduced level of investment activity during 2017/18, as well as the higher rates available in 2016/17 offsetting the increased rates in the second half of 2017/18.

7.5 The original Strategy also anticipated that investments would not exceed £70M during the year unless, for example, new borrowing was undertaken early in the year or the Council's expenditure during the year was later than anticipated. As described in Section 5.3, although £75M of new borrowing was undertaken in the year, it was spread throughout the year. In addition, expenditure within the Capital Programme has increased and been incurred more evenly over the year. Consequently, the level of investments was only briefly higher than expectations and peaked at £70.8M for 1 day on 6 September 2017. The level of investments slowly reduced over the remainder of the year and stood at £37.6M at the end of the financial year.

7.6 All financial investments by the Council's Common Good Funds and Charitable Trusts were made through the Council's Loans Fund, in accordance with the Council's and Common Good Fund's policy for Permitted Investments. As a result, £2,243,000 of Common Good funds and Charitable Trusts were placed on deposit with the Loans Fund for periods of between 6 and 12 months at an average rate of 0.51%.

7.7 Any investments held with external fund managers are outside the scope of the investment regulations, as they all relate to funds held by Council administered Charities or Trusts.

7.8 The Annual Property Investment Strategy for 2017/18 was also approved by the Council at its meeting on the 22 February 2017 (Report 17/81 refers) and was complied with in full, with no breaches in compliance with permitted investment limits.

7.9 The budgeted income from the Council's property portfolio for 2017/18 was originally projected to be £1,732,000, and subsequently increased to £1,738,600. The actual Income for the Council's property portfolio for 2017/18 was £1,967,000. The increase in income relates to the unexpected delay in releasing sites to developers within the Commercial Property portfolio, a number of year-end adjustments made to the portfolio and several rent reviews which resulted in increased rental income.

7.10 There were no additional risks identified or new property investments entered into over the year. The strategy action plan remained on programme.

8. COMPLIANCE WITH TREASURY POLICIES AND LIMITS

8.1 There were no breaches of compliance with the Council's approved borrowing and investment policies and strategy in 2017/18. All aspects of the Prudential Code, including Prudential Indicators and limits, were also fully adhered to throughout the year.

9. CONCLUSION AND RECOMMENDATIONS

9.1 Global economic and political uncertainties have kept UK interest rates low for several years. During 2017/18 longer term rates continued to fall, particularly due to political tensions and uncertainties. There was, however, an increase in the Bank of England base rate in November 2017. With long term rates originally forecast to increase over the year, the borrowing strategy was to undertake borrowing when rates were relatively low. The estimated borrowing requirement was significantly higher in 2017/18 than in previous years, reflecting the increased expenditure in the Capital programme.

9.2 Consequently, during the year £89M of new long term borrowing was undertaken, whilst £8.1M of debt was repaid at maturity and £14.1M of was repaid prematurely. Therefore, the Council's long term PWLB debt portfolio increased over the year by £66.8M, whilst the average interest rate fell to 3.15%.

9.3 There was reduced investment activity as a result of increased cashflow requirements, particularly in relation to the capital programme. Therefore, a higher proportion of investments were with notice accounts and Money Market Funds at lower interest rates to meet liquidity requirements. Investment rates increased in line with the Bank base rate from November 2017.

9.4 There were no breaches of compliance with the lending policy and all Prudential Indicators were complied with throughout the year. As a result of the activities undertaken during 2017/18 the Council's plans remain affordable, prudent and sustainable. The report also includes detailed information on the repayment profiles and future estimates of Loans Fund Advances.

9.5 The Council's Consolidated Loans Fund (CLF) rate for the year reduced from 3.38% last year to 3.19%. The Council's CLF continues to be below the Scottish average, and equates to over £2M in savings compared to the average for Scottish local authorities.

9.6 It is recommended that the Council notes the content of this report, which is submitted in accordance with the Council's approved Treasury Management Practices (TMPs).

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ANNEX

1. IMPLICATIONS, ASSESSMENTS, CONSULTATION AND COMMUNICATION

Strategic Implications	**Yes / None**
Community Plan / Single Outcome Agreement	None
Corporate Plan	Yes
Resource Implications	
Financial	Yes
Workforce	Yes
Asset Management (land, property, IST)	Yes
Assessments	
Equality Impact Assessment	Yes
Strategic Environmental Assessment	Yes
Sustainability (community, economic, environmental)	Yes
Legal and Governance	None
Risk	None
Consultation	
Internal	Yes
External	Yes
Communication	
Communications Plan	None

1. Strategic Implications

1.1. Corporate Plan

1.1.1. The Council's Corporate Plan 2013 – 2018 lays out five outcome focussed strategic objectives which provide clear strategic direction, inform decisions at a corporate and service level and shape resources allocation. They are as follows:

(i) Giving every child the best start in life;
(ii) Developing educated, responsible and informed citizens;
(iii) Promoting a prosperous, inclusive and sustainable economy;
(iv) Supporting people to lead independent, healthy and active lives; and
(v) Creating a safe and sustainable place for future generations.

1.1.2 This report relates to all of these objectives.

2. Resource Implications

2.1. Financial

2.1.1. There are no direct financial implications arising from this report other than those reported within the body of the main report.

2.2. Workforce

2.2.1. There are no direct workforce implications arising from this report other than those reported within the body of the main report.

2.3. Asset Management (land, property, IT)

2.3.1. There are no direct asset management implications arising from this report other than those reported within the body of the main report.

3. Assessments

3.1. Equality Impact Assessment

3.1.1. Under the Equality Act 2010, the Council is required to eliminate discrimination, advance equality of opportunity, and foster good relations between equality groups. Carrying out Equality Impact Assessments for plans and policies allows the Council to demonstrate that it is meeting these duties.

3.1.2. The information contained within this report has been considered under the Corporate Equalities Impact Assessment process (EqIA) and has been assessed as **not relevant** for the purposes of EqIA.

3.2 Strategic Environmental Assessment

3.2.1 The Environmental Assessment (Scotland) Act 2005 places a duty on the Council to identify and assess the environmental consequences of its proposals.

3.2.2 The information contained within this report has been considered under the Act. However, no action is required as the Act does not apply to the matters presented in this report.

3.3 Sustainability

3.3.1 Under the provisions of the Local Government in Scotland Act 2003 the Council has to discharge its duties in a way which contributes to the achievement of sustainable development. In terms of the Climate Change Act, the Council has a general duty to demonstrate its commitment to sustainability and the community, environmental and economic impacts of its actions.

3.3.2 The information contained within this report has been considered under the Act. However, no action is required as the Act does not apply to the matters presented in this report.

4. Consultation

4.1 The Chief Executive, and the Council's Treasury advisors, Capita Asset Services, have been consulted in the preparation of this report.

5. BACKGROUND PAPERS

5.1 No background papers, as defined by Section 50D of the Local Government (Scotland) Act 1973 (other than any containing confidential or exempt information) were relied on to any material extent in preparing the above report.

6. APPENDICES

Appendix I – PWLB Fixed Maturity Interest Rates From 1 April 2017 to 1 April 2018.

Appendix II – Average Loans Fund Rates.