PERTH AND KINROSS COUNCIL

19 June 2019

ANNUAL TREASURY REPORT 2018/19

Report by Head of Finance (Report No. 19/190)

PURPOSE OF REPORT This report summarises the Council's treasury activities for the 2018/19 financial year and compares actual performance with the approved Treasury and Investment Strategy for 2018/19.

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 7 March 2018 approved the Treasury Strategy for the 5 financial years 2018/19 to 2022/23 and the annual Investment Strategy for 2018/19 (Report No. 18/67 refers).

1.2 This Annual Treasury Report covers:

- The Council's treasury position
- The forecast economic outlook and borrowing strategy for 2018/19
- The actual economic situation for 2018/19
- Actual long term borrowing and repayments in 2018/19
- The Statutory Loans Fund position
- The Investment Strategy and outturn for 2018/19
- Compliance with treasury policies and limits during 2018/19

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 31 Mar 2018 £M	Average Rate %	Principal 31 Mar 2019 £M	Average Rate %
Fixed Rate/Long Term Funding				
• Public Works Loan Board (PWLB)	310.0	3.15	340.0	3.03
• Market & Local Authority Bonds	43.2	4.59	43.2	4.59
• Other Loans & Bonds*	0.5	0.00	0.4	0.00
	353.7	3.32	383.6	3.20
Variable Rate/Short Term Funding				
• Temporary Loans	2.5	0.17	2.4	0.18
• Internal Loans	2.3	0.51	2.1	1.04
	4.8	0.33	4.5	0.59
TOTAL DEBT	**358.5**	**3.28**	**388.1**	**3.17**
SHORT TERM INVESTMENTS	**37.6**	**0.73**	**50.8**	**1.01**
*Interest free loans from Salix and the Scottish Government				

3. THE FORECAST ECONOMIC OUTLOOK AND BORROWING STRATEGY 2018/19

3.1 Following a period of above-target inflation and rising economic activity it was anticipated that there would be gradual increases in interest rates, with only one increase in the Bank base rate expected during the year. The Council's Treasury strategy for 2018/19 was, therefore, based on the view that interest rates were expected to remain relatively low throughout most of the year. In addition, the volatility in the global economy was expected to continue, particularly around the "Brexit" negotiations and political and economic uncertainties. This made it difficult to forecast interest rates with any degree of certainty. Subject to this uncertainty, medium and longer term interest rates were expected to rise slowly throughout 2018/19 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 increase gradually from 0.50% at the start of the year, with only 2 rises of 0.25% over the next 2 years. The increases in the Bank Rate could be brought forward if inflation remained high, however uncertainty surrounding "Brexit" negotiations meant that any increase could be delayed further. 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 would slowly increase during the year, with the rate for 10 year borrowing rising from 2.30% to around 2.5% by the end of the year (March 2019). For 50 year borrowing, rates were expected to increase from 2.46% to around 2.90%.

3.3 The estimated capital borrowing for 2018/19 at the start of the year was £51.6M, with the new borrowing requirement over the remaining four year period of the Capital programme totalling £230.1M. This included refinancing maturing debt over the period and reflected the borrowing requirement of the Capital Budget approved by the Strategic Policy & Resources Committee in February 2018. The borrowing requirement was also significant as the start of 2018/19 coincided with the period of low forecast interest rates, whilst both the borrowing requirement and interest rates 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. Therefore, given the forecasts outlined above, consideration was to be given to borrowing for future year requirements earlier within the 5 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 also 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 2018/19

4.1 2018/19 was another unsettled year for the financial markets. Economic growth in the UK was 0.4% in the first quarter, rising to 0.6% in the second quarter, before falling to 0.2% by the final quarter. At the same time, Consumer Price Index (CPI) inflation steadily fell over most of the year from 2.4% at the start of the year to 1.8% in March 2019. Unemployment levels also fell throughout the year whilst average earnings exceeded the rate of inflation for most the year.

4.2 However, the most significant factor affecting the economic situation in the UK was the continuing uncertainty around the impact of “Brexit” and the ongoing withdrawal negotiations. However, global political tensions in America and China and the threat of increased trade tariffs also impacted the financial markets, resulting in ongoing volatility. After briefly falling sharply in May, gilt yields increased gradually over the first half of the year due to anticipated increases in the Bank base rate. However, due to growing political uncertainties as Brexit deadlines came closer, yields subsequently drifted lower as investors sought safe-haven investments. Towards the end of the financial year, rates fell sharply as a result of the growing uncertainties.

4.3 The Bank of England’s Monetary Policy Committee (MPC) increased the Bank base rate to 0.75% in August 2018 as economic activity improved and inflation remained above target. The MPC also advised that subsequent increases would be necessary, however they would be gradual. Subsequently, economic activity and inflation declined in the UK and globally. At the same time, “Brexit” negotiations intensified towards the end of the year, particularly in March 2019. This resulted in longer dated gilt yields falling towards the end of the year, as well as pushing back expectations of increases in the Bank Base Rate.

4.4 Consequently, the 10 year PWLB was 2.23% at the start of the year, and fell to 2.1% by the end of May 2018. This was followed by a period of increases until they peaked at 2.50% in October, before steadily falling to their low point of 1.80% at the end of March 2019. The 50 year rate followed a similar pattern, starting the year at 2.29%, falling to 2.25% in May 2018, and then rising to peak at 2.79% in October. This was followed by steady declines to their low point of 2.16% at the end of March 2019. All PWLB fixed rates were lower than forecast in the original strategy.

4.5 Various PWLB Certainty 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.

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 future. The average rate on the Council’s investments at the start of the year was 0.73%, which increased to 1.01% at the end of the year.

5. ACTUAL LONG TERM BORROWING & REPAYMENTS

5.1 The actual treasury activities during 2018/19 were comprehensively detailed in the four quarterly Treasury reports previously submitted to the Council (Report No’s 18/323, 18/415, 19/58 and 19/126 refer).

5.2 As noted in paragraph 3.3 above, before the start of the year, the Council's estimated new capital borrowing for 2018/19 was £51.6M, and the actual borrowing 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 £40M of new longer-term borrowing was undertaken over the course of the year from the PWLB at an average rate of 2.20% and for an average period of 39 ½ years. This consisted of:

- £10M in May 2018, for 50 years at 2.25%
- £10M in December 2018, for 49 years at 2.38%
- £20M in March 2019, of which £5M was borrowed for 9 years at 1.93%, £5M for 10 years at 1.90% and £10M for 50 years at 2.24%.

5.4 The reduced borrowing reflected some slippage in the capital budget during the year as well as a positive cashflow for the Council. In addition, with the political uncertainties continuing to affect the financial markets, the low borrowing rates were expected to continue for some time longer. Consequently, delaying some new borrowing reduced the increase in the level of investments in the short term.

5.5 The Council's scheduled repayments to the PWLB during the year related to 2 maturing loans which had been borrowed for 9 and 9 ½ years totalling £10M at an average interest rate of 3.44%. The average PWLB debt portfolio rate for the Council reduced from 3.15% at the start of the year, to 3.03% for the total of £340M of PWLB debt held by the Council at 31 March 2019.

5.6 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 £29.9M to £383.6M, whilst the average rate reduced from 3.32% to 3.20%.

5.7 Short term variable funding at the year-end reduced slightly from £4.8M at 31 March 2018 to £4.5M at 31 March 2019. The reduction mostly relates to a reduced level of internal deposits from the Common Good and Charities over the year.

5.8 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 3.19% in 2017/18 to 3.00% in 2018/19 (based on applying statutory guidance). This decrease reflects the impact of borrowing at lower rates and the full impact of the debt rescheduling exercises undertaken during the previous year.

5.9 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 2018/19 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 £2.9M 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 in the short-term due to, 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 The approved Loans Fund policies allow the amortisation of capital expenditure (advances) for periods of up to 50 years in line with the asset useful lives, using the annuity method. The repayment of Loans Fund advances are also deferred until the asset being funded is completed and operational.

6.4 It is a requirement of the Loans Fund 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 at 31 March 2019 is £432,324,498 (subject to completion and audit of the Council's Annual Accounts). This is made up as follows:

- Capital Advances outstanding 1 April 2018 - £399,997,423
- Add New capital Advances 2018/19 - £44,854,932
- Less Capital Advances repaid in the year - £12,527,857

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	3,804	2,751	**6,555**	4,443	**10,998**
Between 1 and 2 Years	3,823	2,632	**6,455**	3,980	**10,435**
Between 2 and 5 Years	10,295	6,001	**16,296**	10,149	**26,445**
Between 5 and 10 Years	10,201	5,194	**15,395**	22,032	**37,427**
Between 10 and 15 Years	2,278	3,881	**6,159**	21,988	**28,147**
Between 15 and 20 Years	21,709	2,970	**24,679**	13,829	**38,508**
Between 20 and 25 Years	25,862	2,834	**28,696**	3,455	**32,151**
Between 25 and 30 Years	34,049	3,451	**37,500**	2,360	**39,860**
Between 30 and 35 Years	37,139	4,290	**41,429**	6,218	**47,647**
Between 35 and 40 Years	38,511	4,959	**43,470**	6,064	**49,534**
Between 40 and 45 Years	52,387	3,074	**55,461**	4,427	**59,888**
Between 45 and 50 Years	40,867	2,236	**43,103**	5,009	**48,112**
Over 50 Years	3,172	0	**3,172**	0	**3,172**
TOTAL	**284,097**	**44,273**	**328,370**	**103,954**	**432,324**

6.6 Comparison of the capital advances above with the long term external debt shown in paragraph 2.1 demonstrates that actual capital expenditure funded by borrowing is higher than the actual borrowing undertaken to date (around £48.7M). 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 17 April 2019 (report 19/111) 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 10 years as approved in April is as follows:

	Composite Programme	Housing Investment Programme	**TOTAL**
(£'000)			
2019/20	33,776	11,520	**45,296**
2020/21	70,823	6,665	**77,488**
2021/22	88,610	4,064	**92,674**
2022/23	94,087	6,854	**100,941**
2023/24	29,599	24,739	**54,338**
2024/25	10,936	0	**10,936**
2025/26	10,606	0	**10,606**
2026/27	10,427	0	**10,427**
2027/28	8,386	0	**8,386**
2028/29	9,383	0	**9,383**
TOTAL	**366,633**	**53,842**	**420,475**

6.8 All the above Loans Fund repayments and new borrowing 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 also includes estimates of new borrowing in the years beyond 2028/29.

7. INVESTMENT STRATEGY AND OUTURN 2018/19

7.1 Short term deposit rates remained at low levels throughout the year, however they did increase from August 2018 following the increase in the Bank base rate. The low deposit rates also reflect 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 offered by most banks and institutions remained low relative to the bank base rate.

7.2 As a result of the Council's positive cashflow, the level of investments steadily increased in the first half of the year, largely in the form of fixed rate deposits. With less long-term borrowing being undertaken in this period, the level of investments generally reflected the Council's cashflow on a day to day basis. As the cashflow becomes less positive in the second half of the year, the level of investments subsequently reduced. However, with most of the long term borrowing undertaken later in the year, the level of investments did increase again towards the end of the year. The level of investments stood at £37.6M at the start of the year, and peaked at £81.5M in October, before ending at £50.8M at 31 March 2019.

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 bank accounts and shorter term fixed deposits. In particular, notice deposit rates for just over 3 months with some of the banks were particularly competitive and increased relative to other investment rates. These facilities also helped to meet short term cashflow requirements and keep within counterparty limits.

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 2018/19. The average rate on investments outstanding at 31 March 2019 was 1.01% (0.73% at 31 March 2018). This increase in the average rate over the year reflected the increase in the Bank base rate and the notice account rates used. In comparison, the average temporary borrowing rate for the year was 0.37%. Total interest received on investments in 2018/19 amounted to £462,700 (£278,595 in 2017/18). This reflected the increased level of investment activity during 2018/19, as well as the higher rates available.

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 paragraph 5.3, £40M of new borrowing was undertaken in the year, and was spread throughout the year. In addition, some short term borrowing was undertaken in advance of requirements to secure lower rates, whilst expenditure within the Capital Programme reduced from the previous year. Consequently, the level of investments peaked at £81.5M in October 2018. The level of investments subsequently reduced over the remainder of the 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, £2,124,000 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 1.04%.

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 2018/19 was also approved by the Council at its meeting on the 7 March 2018 (Report 18/67 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 2018/19 was originally projected to be £1,707,000, and subsequently increased to £1,717,000. The actual income from the Council's property portfolio in 2018/19 was £1,783,437, a reduction of £87,000 from the position previously reported to Committee. The reduction reflects actual levels of activity through the financial year.

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 2018/19. 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 2018/19 longer term rates continued to fall, particularly due to political tensions and uncertainties. There was, however, an increase in the Bank base rate in August 2018. With long term rates originally forecast to increase over the year, the borrowing strategy was to undertake borrowing when rates were relatively low. However, with long term rates falling to historical low levels during the year, and expected to remain low, the amount of new borrowing was lower than the Borrowing Requirement. The Council's long term PWLB debt portfolio increased over the year by £30M, whilst the average interest rate fell to 3.03%.

9.2 There was increased investment activity as a result of the positive cashflow in the first half of the year, however, investment activity reduced over the remainder of the year. Investment rates increased in line with the Bank base rate from August 2018.

9.3 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 2018/19 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.

9.4 The Council's Consolidated Loans Fund (CLF) rate for the year reduced from 3.19% last year to 3.00%. The Council's CLF continues to be below the Scottish average, and equates to around £2.9M in savings compared to the average for Scottish local authorities.

9.5 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

Corporate Plan

1.1 The Council's Corporate Plan 2018 – 2023 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.

1.2 This report relates to all of these objectives.

2. Resource Implications

Financial

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

Workforce

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

Asset Management (land, property, IT)

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

3. Assessments

Equality Impact Assessment

3.1 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.

3.2 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.

Strategic Environmental Assessment

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

3.4 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.

Sustainability

3.5 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.

3.6 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.

2. BACKGROUND PAPERS

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.

3. APPENDICES

- Appendix I – PWLB Fixed Maturity Interest Rates From 1 April 2018 to 1 April 2019.
- Appendix II – Average Loans Fund Rates.