APPENDIX 1

SCOTTISH BORDERS COUNCIL

ANNUAL TREASURY MANAGEMENT REPORT YEAR TO 31 MARCH 2018

CONTENTS

1. EXECUTIVE SUMMARY

1.1 This Council is required by regulations issued under the Local Government in Scotland Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2017/18. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

This paper highlights activity in relation to the treasury management function during 2017/18, the Council's strategy with regard to interest rates and future expectations and how the capital expenditure incurred by the Council in 2017/18 was funded. The investment strategy for 2017/18 is summarised in Section 5 and Members are provided with details of how well the treasury function has performed in relation to a set of standard performance indicators.

1.2 During 2017/18, the Council complied with its legislative and regulatory requirements.

1.3 Key Prudential (PI) and Treasury Management Indicators (TI), detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

Table 1	**2017/18 Actual £m**	**2017/18 Estimate £m**	**Variance £m**
Actual Capital Expenditure *(PI-1)**	**36.0**	**56.71**	**(20.7)**
Total Capital Financing Requirement (CFR) ** *(PI-2)*	**306.9**	**301.2**	**5.7**
(Under)/Over Gross Borrowing against the CFR *(PI-6) ****	**(47.6)**	**(25.1)**	**(22.5)**

** Revised estimate, approved by Scottish Borders Council on 21 December 2018 as part of the Mid Year Treasury report 2017/18*
*** The CFR for this calculation includes current capital expenditure to 31 March 2018*
**** The CFR for this calculation includes the current and two future years projected capital expenditure.*

1.4 Additional borrowing for capital purposes was undertaken during 2017/18 amounting to £6m. The statutory borrowing limit (the authorised limit) was not breached.

1.5 The economic environment during the 2017/18 financial year continued to remain challenging, with low investment returns.

2. COUNCIL'S CAPITAL EXPENDITURE AND FINANCING 2017/18

2.1 CAPITAL EXPENDITURE *(Prudential Indicator 1)*

a) The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need, or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

b) The final capital expenditure for 2017/18 was lower than projected as a result of delays in expenditure on a number of projects, including Early Learning and Childcare block expenditure (£2.1m), Hawick regeneration £2.5m, Central Borders Business Park £2.5m, Waste Transfers station £5.2m, Asset rationalisation £1.1m Roads & transport £1.5m and ICT transformation £2.0m.

The specific drivers for each of the movements have been disclosed in the regular monitoring reports to the Executive throughout 2017/18 and in the out-turn report presented on 19 June 2018.

2.2 FINANCING THE CAPITAL PROGRAMME

a) Capital Expenditure may either be financed:

(i) Immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which does not impact on the Council's borrowing need, or

(ii) If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

b) **Table 3** below summarises the main funding elements of the 2017/18 capital expenditure.

Table 3	**2017/18 Actual £m**	**2017/18 Estimate £m**	**Variance £m**
Capital Expenditure	36.0	56.7	(20.7)
Other Relevant Expenditure *	0.0	0.4	(0.4)
Total Expenditure	**36.0**	**57.1**	**(21.1)**
Financed by:			
Capital Grants & Other Contributions	22.4	28.7	6.3
SBC Revenue Funding	0.8	0.4	(0.4)
Capital Fund/Capital Receipts	0.4	1.9	1.5
Plant & Vehicle Fund	1.1	1.3	0.2
Total identified finance	**24.7**	**32.3**	**7.6**
Net Financing Need for the Year	**11.3**	**24.8**	**(13.5)**

The decrease in unfinanced capital expenditure compared with the estimate in the mid-year report resulted principally from timing movements as detailed in paragraph 2.1 b).

2.3 CAPITAL FINANCING REQUIREMENT AND EXTERNAL DEBT *(Prudential Indicators 2 and 5)*

a) The Council's underlying need to borrow for capital expenditure is termed the **Capital Financing Requirement (CFR)** and is a key prudential indicator. The CFR results from the capital activity of the Council and the resources that have been used to pay for the capital spend. It represents the 2017/18 unfinanced capital expenditure (see **Table 3** in section 2.2 (b)), and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

b) Depending on the capital expenditure programme, the treasury function organises the Council's cash position to ensure sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies, such as the Public Works Loan Board or the money markets, or utilising cash resources within the Council.

c) **Reducing the CFR** – the Council's underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the scheduled debt amortisation for loans repayment, to reduce the CFR. This is effectively a repayment of the borrowing need. This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR. The total CFR can also be reduced by:

- the application of additional capital financing resources (such as unapplied capital receipts); or
- charging more than the scheduled debt amortisation for loans repayment.

The Council's borrowing activity is constrained by prudential indicators, including those comparing gross borrowing, the CFR and the authorised limit.

d) The extent to which the Council is under/over borrowed at 31 March 2018 is calculated by comparing actual external debt against the CFR and is shown in **Table 4** below. It includes "Other long term liabilities", such as PFI and leasing schemes on the balance sheet. These increase the Council's borrowing need, however, as no borrowing is actually required against these schemes, these amounts have been deducted in **Table 4**.

Table 4	31 March 2018 Actual £m	31 March 2018 Estimate £m	Variance £m
CFR (PI-2)*	306.9	301.2	5.7
Less: Other long term liabilities **	73.0	72.9	0.1
Underlying borrowing requirement	233.9	228.3	5.6
External Borrowing at 31/3/18	198.2	198.3	0.1
(Under)/Over borrowing	(35.7)	(30.0)	5.7

**The CFR for this calculation includes current capital expenditure to 31 March 2018*
***PPP/PFI/Finance Lease balances*

TREASURY MANAGEMENT ACTIVITY

3.1 GROSS BORROWING AND THE CFR *(Prudential Indicator 6)*

a) In order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the current year (2017/18) plus the estimates of any additional capital financing requirement for the next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2017/18. The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with this prudential indicator.

Table 5	**31 March 2018 Actual £m**	**31 March 2018 Estimate £m**	**Variance £m**
Fixed rate funding			
PWLB	149.7	154.9	(5.2)
Market	5.0	-	5.0
Variable rate funding			
Market *	43.6	43.4	0.2
External Borrowing	**198.3**	**198.3**	**0.0**
Other long term liabilities **	73.0	72.9	0.1
Total Debt	**271.3**	**271.2**	**0.1**
CFR (inc. next 2 year estimates)	316.2	296.3	19.9
(Under)/Over Gross Borrowing against the CFR *(PI-6)*	**(44.9)**	**(25.1)**	**19.8**

* *LOBO loans (where a rate change could be instigated by the lender at certain intervals)*
** *PPP/PFI/Finance Lease balances*

b) Council deposits were made on a short term basis throughout 2017/18.

c) There was no rescheduling of debt during 2017/18. Additional long term (PWLB) borrowing of £10m was undertaken in 2017/18 as well as short term borrowing on £5m towards the year end, which was repaid in full during April 2018.

3.2 OPERATIONAL BOUNDARY AND AUTHORISED LIMIT *(Prudential Indicators 7 and 8)*

a) The **Operational Boundary** and the **Authorised Limit** are indicators which are intended to act as limits to the overall level of borrowing activity. The Authorised Limit represents the maximum limit beyond which borrowing is prohibited. The Operational Boundary represents the level of external borrowing that the Council is expected to operate within. **Table 6** compares the External Debt position with these indicators and demonstrates that the Council has not breached either limit during 2017/18

Table 6	**31 March 2018 Actual £m**	**Authorised Limit** *(PI-8)* **£m**	**Variance £m**	**Operational Boundary** *(PI-7)* **£m**	**Variance £m**
Total Gross Borrowing	**271.3**	**358.7**	**(87.4)**	**298.4**	**(27.1)**

3.3 MATURITY PROFILE OF EXTERNAL DEBT

a) **Table 7** presents an analysis the maturity structure of the Council's external debt portfolio.

Table 7	**31 March 2018 £m**
Under 12 months	5.0
12 months and within 5 years	12.8
5 years and within 10 years	26.1
Over 10 years	154.4
Total	**198.3**

4. INTEREST RATE MOVEMENTS AND EXPECTATIONS

4.1 TREASURY STRATEGY FOR 2017/18

a) The expectation for interest rates within the treasury management strategy for 2017/18 anticipated that Bank Rate would not start rising from 0.25% until quarter 2 2019 and then only increase once more before 31.3.20. (Please check your own TMSS report as the above comment comes from our LAS interest rate forecasts of 15.11.16.) There would also be gradual rises in medium and longer term fixed borrowing rates during 2017/18 and the two subsequent financial years. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

b) During 2017/18 there was major volatility in PWLB rates with little consistent trend for the 25 and 50 year rates. However, shorter rates were on a rising trend during the second half of the year and reached a peak in February/March.

c) The comparison of the annual *average* percentage interest rates to projections within the 2017/18 strategy is set out in **Table 8** below.

Table 8	Bank Rate %	PWLB Rates %		
		5 year	**25 year**	**50 year**
2017/18 Estimate	0.25	1.70	3.00	2.80
2017/18 Actual	0.38	1.80	2.60	2.65
Variance	**0.13**	**0.10**	**0.40**	**0.15**

4.2 THE ECONOMY AND INTEREST RATES – 2017/18

a) During the calendar year of 2017, there was a major shift in expectations in financial markets in terms of how soon Bank Rate would start on a rising trend. After the UK economy surprised on the upside with strong growth in the second half of 2016, growth in 2017 was disappointingly weak in the first half of the year which meant that growth was the slowest for the first half of any year since 2012. The main reason for this was the sharp increase in inflation caused by the devaluation of sterling after the EU referendum, feeding increases into the cost of imports into the economy. This caused a reduction in consumer disposable income and spending power as inflation exceeded average wage increases. Consequently, the services sector of the economy, accounting for around 75% of GDP, saw weak growth as consumers responded by cutting back on their expenditure. However, growth did pick up modestly in the second half of 2017. Consequently, market expectations during the autumn rose significantly that the MPC would imminently raise the Bank Rate. The minutes of the MPC meeting of 14 September indicated that the MPC was likely to raise base rate very soon. The 2 November MPC quarterly Inflation Report meeting duly raised the Bank Rate from 0.25% to 0.50%.

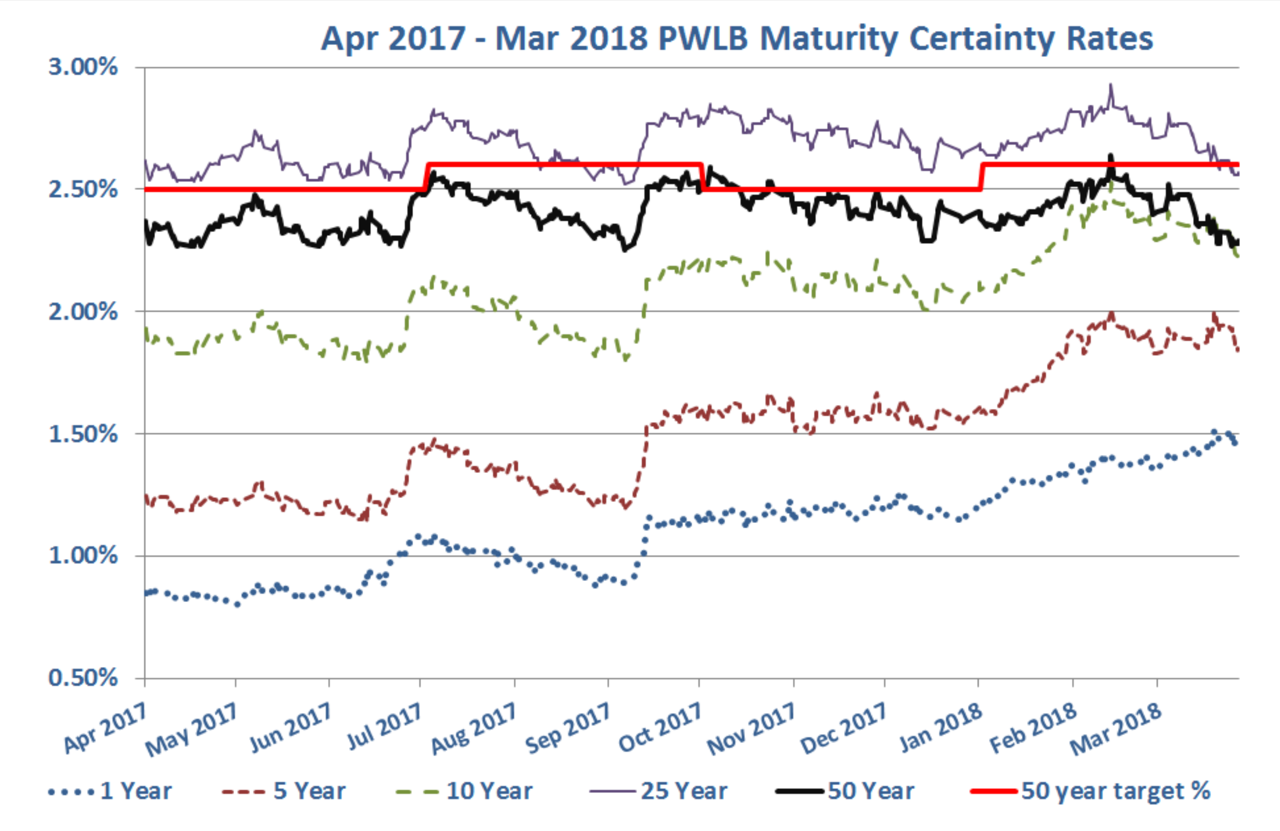
b) The 8 February MPC meeting minutes then revealed another sharp hardening in MPC warnings on a more imminent and faster pace of increases in Bank Rate than had previously been expected.

c) Market expectations for increases in Bank Rate, therefore, shifted considerably during the second half of 2017-18 and resulted in investment rates from 3 – 12 months increasing sharply during the spring quarter.

4.3 BORROWING RATES IN 2016/17

a) PWLB Borrowing Rates

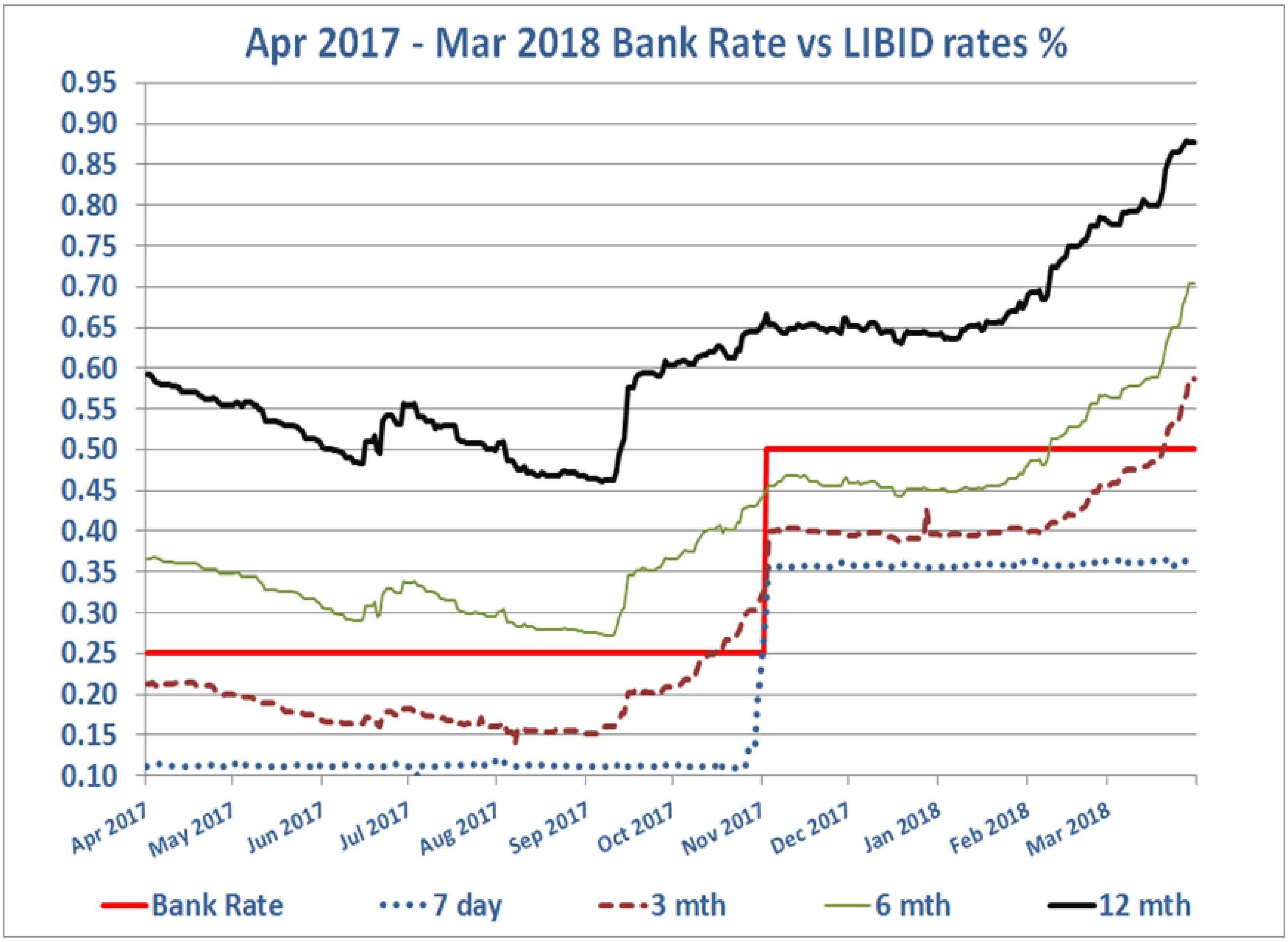
Chart 1 below shows how PWLB certainty rates have fallen to historically very low levels during the year.



4.4 INVESTMENT RATES IN 2016/17

a) Investments rates for 3 months and longer have been on a rising trend during the second half of the year in the expectation of Bank Rate increasing from its floor of 0.25%, and reached a peak at the end of March. Bank Rate was duly raised from 0.25% to 0.50% on 2.11.17 and remained at that level for the rest of the year. However, further increases are expected over the next few years. Deposit rates continued into the start of 2017/18 at previous depressed levels due, in part, to a large tranche of cheap financing being made available under the Term Funding Scheme to the banking sector by the Bank of England; this facility ended on 28.2.18.

b) **Chart 2** below illustrates the change in the Investment Rates certainty maturity rates, for a selection of maturity periods, throughout 2017/18.



5. INVESTMENT STRATEGY FOR 2016/17

5.1 INVESTMENT OBJECTIVES

a) The Council's investment strategy is governed by Scottish Government investment regulations and sets out the approach for choosing investment categories and counterparties, based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc).

c) The **primary objectives** of the Council's investment strategy are:

(i) the safeguarding or **security** of the repayment of the principal and interest of investments on a timely basis;

(ii) ensuring adequate **liquidity** within the Council; and

(iii) maximising investment **yield** or return.

c) The Council will ensure:

(i) It maintains a policy covering the categories of investment types it will invest in, the criteria for choosing investment counterparties with adequate security, and the monitoring of their security; and

(ii) It has sufficient liquidity in its investments. For this purpose it sets out procedures for determining the maximum periods for which funds may prudently be committed. The Council's Prudential Indicators cover the maximum period over which sums can be invested.

5.2 INVESTMENT ACTIVITY

a) The investment activity during the year conformed to the above approved strategy, and the Council had no liquidity difficulties. All money deposited with the Council's bank, Bank of Scotland, was done on an overnight basis to minimise security and liquidity risk to the Council.

5.3 CURRENT INVESTMENT POSITION

a) The total value of investments/deposits for the Council at 31 March 2018 was £7.6m. Cash was held on a short term basis throughout 2017/18 with major banks and various money market funds (the latter having a credit rating of AAA).

6 TREASURY PERFORMANCE INDICATORS

The Treasury Management Function has established the following additional performance indicators.

6.1 DEBT PERFORMANCE INDICATORS

These indicators are additional to the prudential & treasury management indicators covered earlier in this report. The Indicators are:

a) **Average 'Pool Rate'** charged by the Loans Fund compared to Scottish Local Authority average Pool Rate. Target is to be at or below the Scottish Average for 2017/18.

The Council's loans fund pool rate for 2017/18 was 3.97%. The Scottish Local Authority average "pool rate" for 2017/18 is not yet available at the time of writing, but was 4.44% in 2016/17 and is not expected to be materially different for 2017/18.

b) **Average rate movement year on year**. Target is to maintain or reduce the average borrowing rate for the Council versus 2016/17. The Council's pool rate of 3.97% for 2017/18 was 0.35% lower than the reported Council's rate of 2016/17.

6.2 INVESTMENT PERFORMANCE INDICATORS

a) Security

(i) The Council's maximum security risk benchmark for the current portfolio, when compared to historic default tables, is 0.02% historic risk of default.

(ii) During 2017/18, money was deposited in accounts on a short term basis, not exceeding 3 months.

(iii) In September 2017 Moody's altered their long term rating on Bank of Scotland upgrading it by one step from A1 to Aa3. July 2016. This was in line with Bank of

Scotland parent company Llyods Bank PLC. This is one step up from the minimum counter party grading accepted by the Council per the Treasury Management Strategy. This position is being closely monitored.

b) Liquidity

(i) Liquid short term deposits should be at least £3,000,000, available with a week's notice.

(ii) This indicator was adhered to in 2017/18

(iii) Weighted Average Life benchmark is **expected to be 0.5 years** (equivalent to a weighted average life of 6 months), with a **maximum of 1.00 years.**

(iv) The weighted **average life for 2017/18 was 0.01 years**, well below the 0.5 year target.

c) Yield

The target yield is to have internal returns on cash investment above the 7 day LIBID rate. The return for 2017/18 averaged 0.26%, compared against an average 7 day LIBID rate for the year to 31 March 2018 of 0.22%.

2016/17 comparison figures for average internal returns and 7 day LIBID were 0.31% and 0.20% respectively. Therefore, 2017/18 returns showed a continued return in excess of target albeit a falling return from prior years. This is in line with falling Money Market Funds rates.

Although yields remain low, the Council continues to make deposits on a short term basis with the Government's Debt Management Office (DMO) and Money Market Funds. The DMO is a very secure (Credit Rating of AAA) form of investment, but delivers a low rate of return (rising to 0.25% from 0.1% in 2017/18). The Money Market Funds used for deposits are also secure (with a Credit Rating of AAA). The planned deposit allocation between these two investment types has resulted in the returns mentioned above.

6.3 IMPACT ON REVENUE BUDGET

a) Ratio of actual financing costs to net revenue stream *(Prudential Indicator 3)*

This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue funding for the Council. The comparison of the revised estimate approved in the 2017/18 mid year report to the outturn as at 31 March 2018 is as follows:

Table 9	**Actual**	**Estimate**
Ratio of financing costs to net revenue stream *(PI-3)*	**% 9.0**	**% 8.9**

b) Net Cost of Servicing Debt (Loan Charges) – Table 10 below summarises the comparison of the outturn versus estimate for the revenue cost of servicing the debt for the Council, including interest relating to PPP schools unitary charges.

Table 10	**2017/18 Outturn £m**	**2017/18 Mid-Year Estimate £m**	**Variance (Under) /Over £m**
Interest on Borrowing	12.9	13.3	(0.4)
Investment Income	(0.3)	(0.3)	-
Capital Repayments	8.3	8.3	-
Total Loan Charges	**20.9**	**21.3**	**(0.4)**

(i) The interest on borrowing costs represents the interest paid on external debt and to internally managed funds (e.g. Pension Fund, Common Good Funds).

6.4 TREASURY MANAGEMENT INDICATORS *(Treasury Indicators 1 – 5)*

a) The Treasury Indicators (TIs) are shown in **Table 11** below. The Council remained well within these Indicator limits throughout 2016/17

Table 11	**2017/18 Revised Indicator**		**2017/18 Actual as at 31 March 2018**
Upper limits – Debt with fixed and variable interest rates			
Upper limits on fixed interest rates *(TI-1)*	289.5		298.4
Upper limits on variable interest rates *(TI-2)*	101.3		104.4
Maturity Structure of borrowing			
	Upper *(TI-3)*	**Lower** *(TI-4)*	**Actual**
Under 12 months	20%	0%	2.54%
12 months to 2 years	20%	0%	0.00%
2 years to 5 years	20%	0%	6.47%
5 years to 10 years	20%	0%	13.19%
10 years and above	100%	20%	77.80%
Prudential limits for principal sums invested *(TI-5)*			
Cash Deposits < 12 months	100%		100%
Cash Deposits > 12 months	20%		0%

ANNEX A

Indicator Reference	Indicator	Page Ref.	2017/18 Original estimate	2017/18 Revised estimate	2017/18 Actual
PRUDENTIAL INDICATORS					
Capital Expenditure Indicator					
PI-1	Capital Expenditure (£m)	3	42.2	56.7	36.0
PI-2	Capital Financing Requirement (£m) (CFR)	6	293.1	301.2	306.9
Affordability Indicator					
PI-3	Ratio of Financing Costs to Net Revenue	16	9.0%	8.9%	9.0%
PI-4	Incremental Impact of Capital Investment Decisions on Council Tax	N/A	(0.02)	(0.04)	
External Debt Indicators					
PI-5	Actual Debt (£m)	8	265.4	271.2	268.6
PI-7a	Operational Boundary (inc. Other Long Term Liabilities) (£m)	9	285.0	289.5	298.4
PI-7b	Operational Boundary (exc. Other Long Term Liabilities) (£m)	9	212.1	216.5	228.1
PI-8a	Authorised Limit (inc. Other Long Term Liabilities) (£m)	9	343.6	348.0	358.7
PI-8b	Authorised Limit (exc. Other Long Term Liabilities) (£m)	9	270.6	275.0	288.4
Indicators of Prudence					
PI-6	(Under)/Over Gross Borrowing against the CFR (£m)	8	(25.8)	(25.1)	(47.6)
TREASURY INDICATORS					
TI-1	Upper Limit to Fixed Interest Rates based on Net Debt (£m)	16	285.0	289.5	298.4
TI-2	Upper Limit to Variable Interest Rates based on Net Debt (£m)	16	99.8	101.3	104.5
TI-3 & TI-4	Maturity Structure of Fixed Interest Rate Borrowing	16	**Upper**	**Lower**	
	Under 12 months		20%	0%	
	12 months to 2 years		20%	0%	
	2 years to 5 years		20%	0%	
	5 years to 10 years		20%	0%	
	10 years and above		100%	20%	
TI-5	Maximum Principal Sum invested greater than 364 days	16	20%	20%	20%