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AUDIT AND SCRUTINY COMMITTEE
MONDAY, 15TH JANUARY, 2018

A MEETING of the AUDIT AND SCRUTINY COMMITTEE will be held in the COUNCIL CHAMBER, COUNCIL HEADQUARTERS, NEWTOWN ST BOSWELLS on MONDAY, 15 JANUARY 2018 at 10.15 am

As previously agreed, there will be a meeting of Members of the Committee at 9.30 a.m. prior to the main meeting. The primary focus of the informal session will be to carry out the annual self-assessments of Compliance with the Good Practice Principles Checklist and Evaluation of Effectiveness Toolkit from the CIPFA Audit Committees Guidance.

J. J. WILKINSON,
Clerk to the Council,

8 January 2018

BUSINESS		
1.	**Apologies for Absence.**	
2.	**Order of Business.**	
3.	**Declarations of Interest.**	
4.	**Minute.** (Pages 3 - 6) Minute of Meeting of the Audit and Scrutiny held on 13 November 2017 to be approved and signed by the Chairman. (Copy attached.)	5 mins
5.	**Risk Management in Services** Presentation by Executive Director (Transformation) on the strategic risks facing the Council and his service and the internal controls and governance in place to manage/mitigate those risks to demonstrate how risk management is embedded within services. (Verbal presentation).	30 mins
6.	**Internal Audit Work to December 2017** (Pages 7 - 20) Consider report by Chief Officer Audit & Risk on findings from recent work carried out by Internal Audit, including the recommended audit actions agreed by Management to improve internal controls and governance arrangements, and Internal Audit work currently in progress. (Copy attached)	15 mins
7.	**Audit of Housing Benefit - Risk Assessment Report** (Pages 21 - 46) Consider report by Service Director - Customer & Communities detailing the outcome of the Housing Benefit Risk Assessment carried out by Audit Scotland. (Copy attached)	15 mins

8.	**Treasury Management Strategy 2018/19** (Pages 47 - 90) Consider report by Chief Financial Officer on the Council's draft report and Treasury Management Strategy 2018/19 for review and scrutiny prior to presentation for Council approval. (Copy attached.)	30 mins
9.	**Local Government in Scotland - Financial Overview 2016/17** (Pages 91 - 146) Consider report by the Accounts Commission published in November 2017 which provides an outline of the overall financial health of local government and the significant challenges for local government finance that lie ahead. Supplements including 'Scrutiny Tool for Councillors', 'Local Government Pension Scheme 2016/17' and 'Measures taken by Councils to close their funding gaps 2017/18' (Copies attached)	15 mins
10.	**Any Other Audit Items Previously Circulated.**	
11.	**Any Other Audit Items which the Chairman Decides are Urgent.**	

NOTES

1. **Timings given above are only indicative and not intended to inhibit Members' discussions.**

2. **Members are reminded that, if they have a pecuniary or non-pecuniary interest in any item of business coming before the meeting, that interest should be declared prior to commencement of discussion on that item. Such declaration will be recorded in the Minute of the meeting.**

Membership of Committee:- Councillors S. Bell (Chairman), H. Anderson, K. Chapman, J. A. Fullarton, S. Hamilton (Vice-Chairman), N. Richards, H. Scott, R. Tatler and E. Thornton-Nicol and Mr M Middlemiss.

Please direct any enquiries to Judith Turnbull 01835 826556
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SCOTTISH BORDERS COUNCIL
AUDIT AND SCRUTINY COMMITTEE

MINUTES of Meeting of the AUDIT AND SCRUTINY COMMITTEE held in Council Chamber, Council Headquarters, Newtown St Boswells on Monday, 13 November 2017 at 10.15 am

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Present:-	Councillors S Bell (Chairman), H Anderson, J A Fullarton, N Richards, R Tatler and E Thornton-Nicol. Mr M Middlemiss.
Apologies:-	Councillor S. Hamilton.
In Attendance:-	Chief Financial Officer, Chief Officer Audit and Risk, Capital and Investments Manager, Democratic Services Officer (P. Bolson). Mr G Samson - Audit Scotland.

1. WELCOME AND INTRODUCTIONS

The Chairman welcomed those present to the meeting and introduced Mr Michael Middlemiss, the external member of the Audit and Scrutiny Committee.

DECISION
NOTED.

2. MINUTE

There had been circulated copies of the Minute of 25 September 2017.

DECISION
APPROVED for signature by the Chairman.

3. EXTERNAL MEMBERSHIP OF AUDIT AND SCRUTINY COMMITTEE

Ms Stacey explained that there was provision in the Scheme of Administration for three non-voting external members to be appointed to the Audit and Scrutiny Committee during consideration of Audit matters only. Currently, there were two vacancies with Mr Middlemiss holding the third appointment. The appointments were for a three year term and it was agreed that this be included for discussion at the next meeting of the Committee.

DECISION
AGREED that the appointment of external members to the Audit and Scrutiny Committee be considered at the next meeting of the Committee.

4. RISK MANAGEMENT IN SERVICES

4.1 The Chairman welcomed Mr Martin Joyce, Service Director Assets and Infrastructure to the meeting. Mr Joyce explained that included within Assets and Infrastructure were Service Risk Registers for Catering; Cleaning/Facilities; Capital Projects; Design Services (Engineering and Architecture); Environment; Estates; Fleet; Property; Roads; and Waste. These Registers had been developed through the Business Planning Process and were owned by the Service Managers. Reviews were carried out by the Service Director and the Management Team and risks were escalated to the Corporate Management Team as necessary. There were a number of key overarching issues affecting the service including – financial pressures and the requirement for increased efficiency; time/cost/quality/inflation; increased demands and expectations; Government Policies and Legislation; Change Management; staffing resources; and a historical lack of investment. There were also a number of key risks facing the service. From an internal perspective, these included Health and Safety; Legislative Failure; Data Breach; Breach of Codes of Conduct; and non-compliance with policies/procedures; and SOs. Mr Joyce advised that there were a number of external risks, namely Third Party failures involving contractors and design teams; contract management of projects; failure to inspect and maintain assets such as buildings, bridges and roads; and statutory/legislative compliance. Mr Joyce reported that a range of measures in place to manage these risks such as effective project and programme and change management; change control and financial monitoring; the development of KPIs and inclusion of risk and regular monitoring as a key aspect of Business Planning; training, self-evaluation, peer review, inspections and scrutiny. As part of his presentation, Mr Joyce gave examples of the Risk Registers for Hawick FPS and Jedburgh ICC.

4.2 In response to questions, Mr Joyce advised that in terms of Fleet, two names were required on the operating license. A member of staff was currently acting up to this role on an interim basis to fill a vacancy as the Council had been unsuccessful in recruiting to the post. This approach would increase team resilience and go some way to improving succession planning. Mr Joyce confirmed that Health and Safety data was being transferred to LEXI and that measures such as the wearing of body cameras were in place to address operational risk. Members were advised that following an incident in Liberton when a wall collapsed, SBC inspected every freestanding wall within the Council Estate, including boundary and retaining walls and went on to explain that 20% of property was inspected year on year, allowing the service to respond further if required. Mr Joyce explained that in terms of project management, Tier 1 referred to the main contractor and Tiers 2 and 3 related to sub-contractors or so forth down the supply chain. Mr Joyce clarified which organisations were responsible for buildings, depending on whether the building was shared or how it was operated and confirmed that SBC could provide specific expertise should this be required. Managing Risk was monitored regularly and Mr Joyce gave examples of the scope and competency of Risk Registers across the service. He explained that when contractors managed projects under their own systems, SBC would carry out Quality Management assessments to ensure comprehensive coverage of projects. Mr Joyce went on to explain that extensive site investigations were carried out whenever it was possible to do so and enabled mitigation in advance or at an early stage of a project. The Construction Risk Register was reviewed and updated on a monthly basis and included all aspects of any given project. Discussion followed and Mr Joyce clarified a number of points relating to the management of major contracts and in relation to how SBC would respond should major business risks develop within a project. The Chairman thanked Mr Joyce for his attendance.

DECISION
NOTED the presentation.

5. INTERNAL AUDIT WORK TO OCTOBER 2017

5.1 With reference to paragraph 6 of the Minute of 25 September 2017, there had been circulated copies of a report by the Chief Officer Audit and Risk which provided details of the recent work carried out by Internal Audit and the recommended audit actions agreed by Management to improve internal controls and governance arrangements. The work Internal Audit had carried out during the period 1 September to 27 October 2017 was detailed in the report attached to the Agenda. It was noted that during the period, a total of four final Internal Audit reports were issued. There was one recommendation made and this has been accepted by Management for implementation. An Executive Summary of the final Internal Audit reports issued, including audit objective, findings, good practice, recommendations (where appropriate) and the Chief Officer Audit and Risk's independent and objective opinion on the adequacy of the control environment and governance arrangements within each audit area, was included in Appendix 1 to the report. The SBC Internal Audit function conformed to the professional standards as set out in Public Sector Internal Audit Standards (PSIAS) effective 1 April 2013 including the production of this report to communicate the results of the reviews.

5.2 Reference was made to the Internal Audit Final Assurance Reports detailed in the Appendix to the report. Members were advised that, in terms of the Implementation of the

Community Empowerment (Scotland) Act 2015, finalised Local Outcomes Improvement Plans and Locality Plans for the five localities in the Scottish Borders area had been due for publication on 1 October 2017. This deadline had not been met as the Community Planning Strategic Board had not, at that time, approved the final version of the Community Plan. With reference to the Revenues (Council Tax) Assurance Report, one recommendation had been made that Management should re-evaluate the introduction of periodic reviews of claims for Single Occupancy Discount and to ensure that appropriate anti-fraud measures were in place. The LEADER and European Maritime and Fisheries Fund (EMFF) review was assessed for compliance with the requirements of the new Service Level Agreement (SLA) and EC Regulations for the Programme for the period 2014 – 2018. Members were informed that there was now financial risk on Scottish Borders Council due to the potential for disallowance and fines and that the scale of exposure to financial risk would be included in a report to Council in February 2018.

DECISION:
NOTED:

(i) **the final assurance reports issued in the period from 1 September to 27 October 2017 associated with the delivery of the approved Internal Audit Annual Plan 2017/18;**

(ii) **the Internal Audit consultancy and other work undertaken in this period; and**

(iii) **the assurance provided on internal controls and governance arrangements in place for the areas covered by this Internal Audit work.**

6. PROGRESS WITH IMPLEMENTATION OF INTERNAL AUDIT RECOMMENDATIONS

There had been circulated copies of a report by the Chief Officer Audit and Risk providing an update and overview to the Committee on the status and implementation by Management of audit recommendations previously agreed in Internal Audit reports. Information relating to Internal Audit recommendations which had not yet been fully implemented was detailed in the Appendix to the report and Members noted that the completion dates for a number of these had been extended. Discussion followed and Ms Stacey advised that recommendations were now assigned more realistic timescales for completion. There were two overdue recommendations relating to Roads Management and Mr Joyce advised that these were linked to the ongoing Roads Review and changes in senior management personnel. Work was now in progress to consolidate ICT and improve processes and reporting. With regard to the Road Maintenance Manual, Mr Joyce confirmed that a draft Manual had been developed and he would arrange for an interim update to be provided to Members. Ms Stacey answered questions relating to the format of the Appendix and advised that, with regard to the delay in implementation of recommendations relating to Corporate and Social Work Complaints, the original due date had been over-ambitious but Officers were now more confident that the new date was achievable.

DECISION
ACKNOWLEDGED satisfaction with the progress made by Management in implementing audit recommendations.

7. INTERNAL AUDIT MID-TERM PERFORMANCE REPORT 2017/18

With reference to the Minute of the Audit and Risk Committee of 28 March 2017, there had been circulated copies of a report and Appendix by the Chief Officer Audit and Risk informing the Committee of progress made towards completing the Internal Audit Plan for 2017/18 up to 30 September 2017. The report summarised the statutory obligations for Internal Audit and requirements of the Public Sector Internal Audit Standards and explained the Objectives of Internal Audit were set out in its Charter and formed part of Scottish Borders Council system of Corporate Governance. Ms Stacey reported that good progress had been made during the first six months of the year and that Internal Audit was on target to complete its Annual Plan 2017/18. This was the first mid-term report that had been presented to the new Audit and Scrutiny Committee since the Local Government elections in May 2017 and Ms Stacey explained the format of the Appendix. With regard to Financial Governance, the Payroll, Sales to Cash, Procure to Pay and Record to Report audit headings in this category were now processes within the Business World ERP system and would in future be included in integrated reviews. The work would be carried out in stages and presented back to the Committee in due course. Ms Stacey introduced Ms Diane Cockburn who had taken up post as Internal Auditor and explained that recent changes in staffing now meant that Internal Audit resources were in place to deliver the Internal Audit Annual Plan 2017/18 in full. With reference to new General Data Protection Regulations (GDPR) that came into effect in May 2018, Ms Stacey confirmed that the Council's Information Governance Group (IGG) met regularly and had agreed to the setting up of a Project Group to consider GDPR issues. Ms Stacey responded to further questions raised by Members.

DECISION

(a) APPROVED the progress made by Internal Audit in completing the Internal Audit Annual Plan 2017/18.

(b) ACKNOWLEDGED that it was satisfied with the performance of the Internal Audit service.

8. MID-TERM TREASURY MANAGEMENT REPORT 2017/18

There had been circulated copies of a report by the Chief Financial Officer presenting the mid-year report of treasury management activities for 2017/18 to Audit and Scrutiny Committee in line with the requirements of the CIPFA Code of Practice including Prudential and Treasury Management Indicators. The report was required as part of the Council's Treasury management regime and indicated that Treasury activity during the six months to 30 September 2017 had been undertaken in full compliance of the Treasury and Strategy. The Appendix to the report contained an analysis of the performance against targets and proposed revised estimates of the indicators in light of the 2016/17 outturn and experience during 2017 to date. An additional financial indicator had been included in Annex A of the Appendix under Affordability Indicator (PI-3) to show the Ratio of Financing Costs to Net Revenues including PPP financing and repayment costs. Members requested clarification on a number of points contained in the Appendix and these were answered by officers.

DECISION

(a) NOTED that treasury management activity in the six months to 30 September 2017 was carried out in compliance with the approved Treasury Management Strategy and Policy.

(b) AGREED that the Mid-Year Treasury Management Report 2017/18, as detailed in the Appendix to the report, be presented to Council for approval of the revised indicators.

The meeting concluded at 12.25 pm

INTERNAL AUDIT WORK TO DECEMBER 2017

Report by Chief Officer Audit and Risk

AUDIT AND SCRUTINY COMMITTEE

15 January 2018

1 PURPOSE AND SUMMARY

1.1 The purpose of this report is to provide members of the Audit and Scrutiny Committee with details of the recent work carried out by Internal Audit and the recommended audit actions agreed by Management to improve internal controls and governance arrangements.

1.2 The work Internal Audit has carried out in the period from 28 October to 22 December 2017 is detailed in this report. During this period a total of 8 Final Internal Audit Reports have been issued. There were 4 recommendations made relating to 2 of the reports which have been accepted by Management for implementation.

1.3 An Executive Summary of the final Internal Audit reports issued, including audit objective, findings, good practice, recommendations (where appropriate) and the Chief Officer Audit and Risk's independent and objective opinion on the adequacy of the control environment and governance arrangements within each audit area, is shown in Appendix 1 to this report.

1.4 The SBC Internal Audit function conforms to the professional standards as set out in Public Sector Internal Audit Standards (PSIAS) (2017) including the production of this report to communicate the results of the reviews.

2 RECOMMENDATIONS

2.1 I recommend that the Audit and Scrutiny Committee:

a) Notes the final assurance reports issued in the period from 28 October to 22 December 2017 associated with the delivery of the approved Internal Audit Annual Plan 2017/18;

b) Notes the Internal Audit consultancy and other work undertaken in this period; and

c) Acknowledges the assurance provided on internal controls and governance arrangements in place for the areas covered by this Internal Audit work.

3 PROGRESS REPORT

3.1 The Internal Audit Annual Plan 2017/18 was approved by the Audit and Risk Committee on 28 March 2017. As previously stated, it should be considered to be flexible and will be periodically reviewed, and amended as required, to reflect any new arrangement or changing risks and priorities of the Council. Any amendments will be brought to this Committee for approval.

3.2 Internal Audit has carried out the following work in the period from 28 October to 22 December 2017, associated with the delivery of the approved Internal Audit Annual Plan 2017/18, to meet its objective of providing an opinion on the efficacy of the Council’s risk management, internal control and governance.

3.3 The SBC Internal Audit function conforms to the professional standards as set out in Public Sector Internal Audit Standards (PSIAS) (2017) including the production of this report to communicate the results of the reviews.

Internal Audit Reports

3.4 Internal Audit issued final assurance reports on the following subjects:

- Contract Management
- Peebles High School
- Berwickshire High School
- Selkirk High School
- Morebattle Primary School
- Duns Primary School
- St Boswells Primary School
- Industrial and Business Premises

3.5 An Executive Summary of the final Internal Audit assurance reports issued, including audit objective, findings, good practice and recommendations (where appropriate), and the Chief Officer Audit and Risk’s independent and objective opinion on the adequacy of the control environment and governance arrangements within each audit area, is shown in Appendix 1.

The definitions for Internal Audit assurance categories, as outlined in the approved Internal Audit Charter, are as follows:

Level	Definition
Comprehensive assurance	Sound risk, control, and governance systems are in place. These should be effective in mitigating risks to the achievement of objectives. Some improvements in a few, relatively minor, areas may be required.
Substantial assurance	Largely satisfactory risk, control, and governance systems are in place. There is, however, some scope for improvement as current arrangements could undermine the achievement of objectives or leave them vulnerable to error or misuse.
Limited assurance	Risk, control, and governance systems have some satisfactory aspects. There are, however, some significant weaknesses likely to undermine the achievement of objectives and leave them vulnerable to an unacceptable risk of error or misuse.
No assurance	The systems for risk, control, and governance are ineffectively designed and operated. Objectives are not being achieved and the risk of serious error or misuse is unacceptable. Significant improvements are required.

Current Internal Audit Assurance Work in Progress

3.6 Internal Audit assurance work in progress to complete the delivery of the Internal Audit Annual Plan 2017/18 consists of the following:

Audit Area	Audit Stage
Petty Cash Review and Emergency Funding	Drafting the report
Capital Investment	Follow up nearly completed
Financial Governance (incorporating Payroll, Procure to Pay, Sales to Cash, and Record to Report)	Testing Underway

Internal Audit Consultancy and Other Work

3.7 Internal Audit staff have been involved in the following to meet its aims and objectives, and its roles and responsibilities in accordance with the approved Internal Audit Charter:

3.7.1 Completing the review on ICT Security by way of input to the Council's response to Scottish Government on the draft public sector action plan on cyber resilience, and consideration of cyber resilience essentials including reliance on ICT security risk, control, and governance systems in place to confirm its compliance with the requirements of the Public Services Network (PSN).

3.7.2 Offering advice on internal controls and governance to Managers on request through engagement in a number forums as the Council continues to transform its services. For example, Information Governance Group, and Business World ERP Project Board.

3.7.3 Liaising with the Corporate Risk Officer on an on-going basis to ensure that risk is considered in every audit and risk reviews take account of improvements arising from audit work.

3.7.4 Providing intelligence via data sharing requests from Police Scotland. Liaising with the Corporate Fraud & Compliance Officer on an on-going basis to ensure fraud risk is considered in every audit.

3.7.5 In its 'critical friend' role, providing internal challenge on the planned programme of "How Good is Your Council" assessment and evidence completed by various Services to support self-evaluation and improvement as part of the Performance Management Framework.

Recommendations

3.8 Recommendations in reports are suggested changes to existing procedures or processes to improve the controls or to introduce controls where none exist. The grading of each recommendation reflects the risk assessment of non-implementation, being the product of the likelihood of the risk materialising and its impact:

Priority 1: Significant weaknesses in existing controls, leaving the Council or Service open to error, fraud, financial loss or reputational damage, where the risk is sufficiently high to require immediate action within one month of formally raising the issue. Added to the relevant Risk Register and included in the relevant Assurance Statement.
Priority 2: Substantial weaknesses in existing controls, leaving the Council or Service open to medium risk of error, fraud, financial loss or reputational damage requiring reasonably urgent action within three months of formally raising the issue.
Priority 3: Moderate weaknesses in existing controls, leaving the Council or Service open to low risk of error, fraud, financial loss or reputational damage requiring action within six months of formally raising the issue to improve efficiency, effectiveness and economy of operations or which otherwise require to be brought to the attention of senior management.
Outwith the report, Internal Audit informs operational managers about other matters as part of continuous improvement.

3.9 The table below summarises the number of Internal Audit recommendations made during 2017/18:

	2017/18 Number of Recs
Priority 1	0
Priority 2	2
Priority 3	2
Sub-total reported this period	**4**
Previously reported	16
Total	**20**

Recommendations agreed with action plan	20
Not agreed; risk accepted	0
Total	**20**

4 IMPLICATIONS

4.1 Financial

There are no costs attached to any of the recommendations in this report.

4.2 Risk and Mitigations

(a) The Objectives of Internal Audit are set out in its Charter. "As part of Scottish Borders Council's system of corporate governance, Internal Audit's purpose is to support the Council in its activities designed to achieve its declared objectives." Specifically as "a contribution to the Council's corporate management of risk, including assisting Management to improve the risk identification and management process in particular where there is exposure to significant financial, strategic, reputational and operational risk to the achievement of the Council's objectives."

(b) Key components of the audit planning process include a clear understanding of the Council's functions, associated risks, and potential range and breadth of audit areas for inclusion within the plan. During the development of the Internal Audit Annual Plan 2017/18, to capture potential areas of risk and uncertainty more fully, key stakeholders have been consulted and risk registers have been considered.

(c) If audit recommendations are not implemented, there is a greater risk of financial loss and/or reduced operational efficiency and effectiveness, and Management may not be able to demonstrate improvement in internal control and governance arrangements, and effective management of risks.

4.3 Equalities

It is anticipated there will be no adverse impact due to race, disability, gender, age, sexual orientation or religious/belief arising from the work contained in this report.

4.4 Acting Sustainably

There are no direct economic, social or environmental issues in this report.

4.5 Carbon Management

No direct carbon emissions impacts arise as a result of this report.

4.6 Rural Proofing

This report does not relate to new or amended policy or strategy and as a result rural proofing is not an applicable consideration.

4.7 **Changes to Scheme of Administration or Scheme of Delegation**

No changes are required as a result of this report.

5 CONSULTATION

5.1 The Executive/Service Directors relevant to the Internal Audit reports issued have signed off the relevant Executive Summary within Appendix 1.

5.2 The Corporate Management Team has been consulted on this report and any comments received taken into account.

5.3 The Chief Financial Officer, the Monitoring Officer, the Chief Legal Officer, the Service Director HR, and the Clerk to the Council have been consulted on this report and any comments received have been incorporated into the report.

Approved by

Jill Stacey, Chief Officer Audit and Risk   Signature ....

Author(s)

Name	Designation and Contact Number
Jill Stacey	Chief Officer Audit and Risk Tel 01835 825036

Background Papers: Appropriate Internal Audit files
Previous Minute Reference: Audit and Scrutiny Committee 13 November 2017

Note – You can get this document on tape, in Braille, large print and various computer formats by using the contact details below. Information on other language translations can also be given as well as provision of additional copies.

Contact us at Internal Audit intaudit@scotborders.gov.uk

APPENDIX 1

Report	Summary of key findings and recommendations	Recommendations			Status
		1	2	3	
Audit Plan Category: Financial Governance Subject: Contract Management No: 002/009 Date issued: 8 January 2018 Level of Assurance: Limited	The purpose of this assurance audit was to assess governance and internal controls in place over contract monitoring arrangements with 3rd parties including the integrated sports and culture trust (LIVE Borders) and the ALEO (SB Cares). In response to a previous Internal Audit recommendation, standalone Procurement and Contract Standing Orders have been developed (approved by Council 27 June 2017) which set out contract management roles and responsibilities within SBC, demonstrating improvements have been made since the previous Internal Audit review. The Contract Management Framework design and development was put on hold until Business World ERP system went live in April 2017 to see what it could offer. Following the Public Pound was to be reviewed and updated and monitoring be undertaken to ensure that contract management was being done across the Council. It was agreed that this would be done as part of the review and revision of the Financial Regulations and associated Procedures required as a result of Business World; this action is still to be progressed. For LIVE Borders, we found that although the contract management clauses within the contract are clearly defined and the key relationships, governance and contract management bodies (as specified in the contract) have been formed, contract management is not yet being fully undertaken in compliance with the contract terms. There is currently no mechanism to provide assurance to SBC that risks are being appropriately managed. For SB Cares, we found that although the contract management clauses within the contract are clearly defined and the key relationships, governance and contract management bodies (as specified in the contract) have been formed and are in operation, the full range of contract monitoring is not yet being undertaken.	0	2	1	Management recognise the importance of a robust approach to contract management and the skills required. Management have accepted the report findings and agreed to implement the recommendations within reasonable timescales though reflecting the challenge that limited resources will have on progress of the improvement actions. Internal Audit will support the implementation of recommendations in its ‘critical friend’ role.

Report	Summary of key findings and recommendations	Recommendations			Status
		1	2	3	
Subject: Contract Management (cont'd)	Internal Audit considers that we are able to provide limited assurance that best practice contract management is in place. Risk, control, and governance systems have some satisfactory aspects. However, there is an opportunity for the Council to lead the way in establishing a robust contract management to meet best practice guidance in support of evidencing the application of the Following the Public Pound principles and delivering Best Value. We made the following recommendations: • The work to design and develop an effective Contract Management Framework should be progressed, a contract management culture should be embedded across the Council, and consideration should also be given to including Contract Management skills as part of the broad set of commercial skills which Managers are expected to possess to effectively manage Council Services. (P3) • Contract Monitoring arrangements for LIVE Borders should be enhanced to comply with best practice guidance including the provision of assurance on managing risks. Furthermore it should be made clear in the Scheme of Administration whether the Major Contracts Governance Group's remit will include oversight, scrutiny and challenge of LIVE Borders. (P2) • Contract Monitoring arrangements for SB Cares should be enhanced to comply with best practice guidance. As this contract is large and high risk, it is likely that a multi-disciplinary team will be required to manage the contract, with members from Adult Social Care, Legal, Health and Safety, Finance, Information Governance amongst others. The Internal Audit Recommendation to form a multi-disciplinary Corporate Support Service Forum to support ICT in its contract monitoring activities (yet to be established) could meet this requirement. (P2)				First recommendation will be led by Executive Director (Commercial) with support from Procurement and HR; completion by March 2019. Second and third recommendations will be led by Executive Director (Commercial) and Chief Social Work Officer respectively with completion by June 2018.

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Report	Summary of key findings and recommendations	Recommendations			Status
		1	2	3	
Audit Plan Category: Internal Controls Subject: Peebles High School No: 127/026 Date issued: 22 December 2017 Level of Assurance: Substantial	The purpose of this assurance audit was to ensure internal financial controls and business administrative procedures are in place to ensure the efficient and effective use of resources in the school establishments. The scope of this audit was to examine and evaluate the key controls in the following areas: Petty Cash Imprests; Inventories; Staffing establishment; Business Continuity Planning; School lets and Income Collection procedures; School Fund; Ordering / Invoice processing procedures; Data Protection / Confidential Waste Management; DSM Budget; Health & Wellbeing. Peebles High School is the largest of the 9 high schools and has a current role of 1,228 pupils. The Acting Rector and newly appointed Business Manager are both well supported by a very experienced Senior Management Team and, specifically for the Business Manager, an experienced Administrative Assistant. Within the school office are a team of experienced staff who complete the day to day administrative activities for the school. All staff are fully aware of the need to follow all the required policies and procedures. During the course of our visit, we found nothing of major concern regarding the financial procedures, and we were able to share Good Practice from other schools. Internal Audit considers that the level of assurance we are able to give is substantial, subject to the sign off of the School Fund accounts by the school's appointed independent reviewer which was outstanding at the time of this audit site visit. Largely satisfactory risk, control, and governance systems are in place. We have made no recommendations.	0	0	0	Management have confirmed factual accuracy of the report and accepted findings.

Report	Summary of key findings and recommendations	Recommendations			Status
		1	2	3	
Audit Plan Category: Internal Controls Subject: Berwickshire High School No: 127/027 Date issued: 21 December 2017 Level of Assurance: Substantial	The purpose of this assurance audit was to ensure internal financial controls and business administrative procedures are in place to ensure the efficient and effective use of resources in the school establishments. The scope of this audit was to examine and evaluate the key controls in the following areas: Petty Cash Imprests; Inventories; Staffing establishment; Business Continuity Planning; School lets and Income Collection procedures; School Fund; Ordering / Invoice processing procedures; Data Protection / Confidential Waste Management; DSM Budget; Health & Wellbeing. Berwickshire High School has a current role of 686 children. Within the school building is a Complex Needs Base. The Head Teacher and Business Manager are both very experienced members of staff. The school office also has a team of experienced staff who complete the day to day administrative activities for the school. All office staff are fully aware of the need to follow the required SBC policies and procedures. During the course of our visit, we found nothing of major concern regarding the financial procedures, and we were able to share Good Practice from other schools. Internal Audit considers that the level of assurance we are able to give is substantial. Largely satisfactory risk, control, and governance systems are in place whilst acknowledging the embedding of the new Business World ERP system, familiarity on which is expected to increase even more over time. We have made no recommendations.	0	0	0	Management have confirmed factual accuracy of the report and accepted findings.

Report	Summary of key findings and recommendations	Recommendations 1	2	3	Status
Audit Plan Category: Internal Controls Subject: Selkirk High School No: 127/028 Date issued: 19 December 2017 Level of Assurance: Substantial	The purpose of this assurance audit was to ensure internal financial controls and business administrative procedures are in place to ensure the efficient and effective use of resources in the school establishments. The scope of this audit was to examine and evaluate the key controls in the following areas: Petty Cash Imprests; Inventories; Staffing establishment; Business Continuity Planning; School lets and Income Collection procedures; School Fund; Ordering / Invoice processing procedures; Data Protection / Confidential Waste Management; DSM Budget; Health & Wellbeing. Selkirk High School has a current role of 384 children. The Business Manager is a very experienced member of staff who is supporting the newly appointed Head Teacher. Within the school office are a team of experienced staff who complete the day to day administrative activities for the school. All staff are fully aware of the need to follow the required policies and procedures. During the course of our visit, we found nothing of major concern regarding the financial procedures, and we were able to share Good Practice from other schools. Internal Audit considers that the level of assurance we are able to give is substantial. Largely satisfactory risk, control, and governance systems are in place whilst acknowledging the embedding of the new Business World ERP system, familiarity on which is expected to increase over time. We have made no recommendations.	0	0	0	Management have confirmed factual accuracy of the report and accepted findings.

Report	Summary of key findings and recommendations	Recommendations			Status
		1	2	3	
Audit Plan Category: Internal Controls Subject: Morebattle Primary School No: 128/020 Date issued: 13 December 2017 Level of Assurance: Substantial	The purpose of this assurance audit was to ensure internal financial controls and business administrative procedures are in place to ensure the efficient and effective use of resources in the school establishments. The scope of this audit was to examine and evaluate the key controls in the following areas: Petty Cash Imprests; Inventories; Staffing establishment; Business Continuity Planning; School lets and Income Collection procedures; School Fund; Ordering / Invoice processing procedures; Data Protection / Confidential Waste Management; DSM Budget; Health & Wellbeing; Support for cluster Primary schools. Morebattle Primary is a small rural school with a current role of 52 children. The Head Teacher, who also has the responsibility for Yetholm Primary School, is experienced and fully aware of the need to follow all the required policies and procedures. During the course of our visit, we found nothing of concern regarding the financial procedures, and we were able to share Good Practice from larger primaries. The introduction of the High School Business Managers having responsibility for cluster Administrators provides the opportunity for consistent administrative processes across the schools. In addition the introduction of Parent Pay reduces financial risk within school establishments. Internal Audit considers that the level of assurance we are able to give is substantial. Largely satisfactory risk, control, and governance systems are in place. We have made no recommendations.	0	0	0	Management have confirmed factual accuracy of the report and accepted findings.

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Report	Summary of key findings and recommendations	Recommendations			Status
		1	2	3	
Audit Plan Category: Internal Controls Subject: Duns Primary School No: 128/021 Date issued: 13 December 2017 Level of Assurance: Substantial	The purpose of this assurance audit was to ensure internal financial controls and business administrative procedures are in place to ensure the efficient and effective use of resources in the school establishments. The scope of this audit was to examine and evaluate the key controls in the following areas: Petty Cash Imprests; Inventories; Staffing establishment; Business Continuity Planning; School lets and Income Collection procedures; School Fund; Ordering / Invoice processing procedures; Data Protection / Confidential Waste Management; DSM Budget; Health & Wellbeing; Support for cluster Primary schools. Duns Primary relocated to the former Berwickshire High School building and opened in August 2017. It has a current role of 345 children. The Head Teacher is experienced and fully aware of the need to follow all the required policies and procedures. During the course of our visit, we found nothing of concern regarding the financial procedures, and we were able to share Good Practice from larger primaries. The implementation of the Business World ERP system has had a significant effect across the Council. With the new system comes training and familiarisation of the changes in process and access to data. This is something which will develop over time and will enhance the effectiveness of internal controls and administrative processes. Internal Audit considers that the level of assurance we are able to give is substantial. Largely satisfactory risk, control, and governance systems are in place. We have made no recommendations.	0	0	0	Management have confirmed factual accuracy of the report and accepted findings.

Report	Summary of key findings and recommendations	Recommendations			Status
		1	2	3	
Audit Plan Category: Internal Controls Subject: St Boswells Primary School No: 128/022 Date issued: 13 December 2017 Level of Assurance: Substantial	The purpose of this assurance audit was to ensure internal financial controls and business administrative procedures are in place to ensure the efficient and effective use of resources in the school establishments. The scope of this audit was to examine and evaluate the key controls in the following areas: Petty Cash Imprests; Inventories; Staffing establishment; Business Continuity Planning; School lets and Income Collection procedures; School Fund; Ordering / Invoice processing procedures; Data Protection / Confidential Waste Management; DSM Budget; Health & Wellbeing; Support for cluster Primary schools. St Boswells Primary is a rural school with a current role of 142 children. The Head Teacher, who also has the responsibility for Newtown St Boswells Primary School, is experienced and fully aware of the need to follow all the required policies and procedures. During the course of our visit, we found nothing of concern regarding the financial procedures, and we were able to share Good Practice from larger primaries. The introduction of the High School Business Managers having responsibility for cluster Administrators provides the opportunity for consistent administrative processes across the schools. In addition the introduction of Parent Pay reduces financial risk. The implementation of the Business World ERP system has had a significant effect across the Council. With the new system comes training and familiarisation of the changes in process and access to data. However ultimately it will result in enhanced controls and administrative practices. Internal Audit considers that the level of assurance we are able to give is substantial. Largely satisfactory risk, control, and governance systems are in place. We have made no recommendations.	0	0	0	Management have confirmed factual accuracy of the report and accepted findings.

Report	Summary of key findings and recommendations	Recommendations 1	2	3	Status
Audit Plan Category: Asset Management Subject: Industrial and Business Premises No: 151/001 Date issued: 5 January 2018 Level of Assurance: Substantial	The purpose of this assurance audit was to assess the corporate governance and financial governance arrangements linked to priorities within the Economic Strategy relating to Industrial and Business Premises and associated estate management. Estates actively markets property available for letting on the Council's website and handles enquiries from interested parties. The occupancy rate is fairly high at approx. 90% and robust processes are in place for issuing invoices to tenants. There is no formal process for analysis of demand for industrial and commercial property. Current and historic demand could however be ascertained from enquires from businesses regarding properties available to rent. Planned sites are developed in line with the Local Plan and within the constraints of available land, finance, planning and resources Whilst the Economic Strategy recognises the need for leveraging external funding the importance of and the approach to doing so, and the circumstances where funding is crucial to successful outcomes is not clearly articulated. Notwithstanding this the Council has had considerable success in recent times in attracting external funding to contribute towards the cost of development. Internal Audit considers that the level of assurance we are able to give is substantial. Largely satisfactory risk, control, and governance systems are in place. We made the following recommendation to enhance governance: • When the Economic Strategy is refreshed: clearer linkages between the development of the industrial and business property estate and the requirements of the Economic Strategy should be established; the approach to increasing the supply of immediately available land and business premises should be set out; and the importance of and approach to securing external funding should be articulated. (P3)	0	0	1	Management have confirmed factual accuracy of the report, welcomed the findings and agreed to implement the recommendation as part of the refresh of the Economic Strategy which is currently underway.

Scottish Borders COUNCIL

AUDIT OF HOUSING BENEFIT – RISK ASSESSMENT REPORT

Report by Service Director – Customer & Communities

AUDIT AND SCRUTINY COMMITTEE

15 January 2018

1 PURPOSE AND SUMMARY

1.1 **This report details the outcome of the Housing Benefit Risk Assessment carried out by Audit Scotland during July 2017.**

1.2 Although Scottish Borders Council demonstrates awareness of what constitutes as effective, efficient and secure benefit delivery, there are six risks arising from this risk assessment and an action plan has been created to address these.

2 RECOMMENDATIONS

2.1 I recommend that the Committee :-

(a) Note the contents of the Audit of Housing Benefit – Risk Assessment Report (Appendix 1).

(b) Note the actions planned by Customer Services to address the risks identified in the Audit Report (Appendix 2).

(c) Note the improvements achieved to date regarding the points identified at 4.2.3 and 4.2.4

3 BACKGROUND

3.1 Under statutory duties, Audit Scotland have responsibility for conducting a Housing Benefit Risk Assessment Programme. The Risk Assessment does not represent a full audit of the Benefit Service but it determines the extent to which the service is meeting its obligations to achieve continuous improvement whilst providing some assurance for the Secretary of State for Social Security in respect of Housing Benefit Administration.

3.2 Audit Scotland previously carried out a risk assessment on Scottish Borders Councils benefit service in March 2014 when they identified one risk to continuous improvement. An action plan was not required at that time.

3.3 The main objective of the Audit is to help Councils improve their benefit service however it also holds Councils to account for any failing services. The audit normally has two phases

3.3.1 A risk assessment phase that identifies risks to continuous improvement.

3.3.2 A focused audit phase that examines the service, or parts of it in more detail if a council is unable or unwilling to address key risks identified in phase one.

3.4 Audit Scotland carried out a risk assessment of the Councils benefit service in July 2017 including a site visit. The final report, which identifies six risks to continuous improvement is attached at appendix 1.

4 AUDIT SCOTLAND SCOTTISH BORDERS COUNCIL AUDIT OF HOUSING BENEFIT RISK ASSESSMENT REPORT

4.1 Following the previous risk assessment report carried out on Scottish Borders Council in March 2014 which identified one risk to improvement, the Council contributed positively to the delivery of the benefit service by developing an annual programme of intervention activity focusing on customers considered to be at high-risk of having an unreported change event.

4.2 The report highlighted that although the council demonstrates awareness of what constitutes an effective, efficient and secure benefit service, there are six new risks arising from this risk assessment, as follows :

4.2.1 There is a significant risk that based on current resource levels, the benefit service will be unable to maintain or improve on previous performance.

4.2.2 The performance of the benefit service is not being formally reported to the relevant Council monitoring committee and, in addition, performance in respect of the recovery of all benefit overpayments is not being formally reported to senior management out with the Customer Advice & Support Service, or to elected members as part of the Council's performance management framework.

4.2.3 The average time taken to process new claims and change events has declined significantly in quarter one of 2017/18.

4.2.4 Accuracy performance declined significantly in 2016/17.

4.2.5 The benefit service is not formally recording the outcomes from all of its management checking activities, and therefore unable to report on the accuracy of the service as a whole.

4.2.6 Although interventions outcomes are recorded, the level of detail is not sufficient to allow the council to determine the effectiveness of its approach in financial terms, or the effectiveness of each monthly intervention campaign, which could help ensure that future activity is informed, risk-based and cost effective.

4.3 With regard to the risk identified at 4.2.3 and 4.2.4 the decline is due to a combination of a loss of experienced staff, the reduction in administration funding from the Department for Work and Pensions and a reduction in the level of overtime worked. This is within the context of having to manage a service which will reduce from 2018 when Universal Credit full service is introduced locally.

4.4 The report also highlights that there have been some significant changes within the benefit service, including a restructure in 2014 to merge front and back office operations to provide a more streamlined service as well as the more recent service review which commenced in 2016 to bring the benefit service in to the newly formed Customer Advice & Support Service. This restructure has taken an extended period of time which affected the Services ability to address performance issues and forward plan.

4.5 With regard to the risk identified at 4.2.5 this relates to checks amounting to over £500 payments which although carried out, were not formally recorded against employee performance.

4.6 Performance in the risk areas identified at 4.23 and 4.24 have improved and continue to improve from the position at the time of the audit. Average processing time for new claims and change of circumstances have changed from 29 days and 8 days to 25 days and 8 respectively. Accuracy has changed from 82% to 92%

4.7 Although not detailed in the Audit Scotland report, it is worth noting that there has been a 25.6% reduction in administration funding from the the Department for Work and Pensions between 2014/15 and 2017/18 however our Housing Benefit caseload has only reduced by 8.9%.

4.8 The report is also silent on another key measure which is the cost of administering a benefit claim. This is a performance measure which is benchmarked with all local authorities in Scotland via CIPFA Directors of Finance. Scottish Borders Council has one of the lowest costs of administration and this must be balanced against other measurement such as processing times.

4.9 The Service, like others, is facing significant operational challenges in relation to Welfare Reform changes, in particular the introduction of Universal Credit (UC). The full service is due to be rolled out locally this year leading to a significant increase in the number of people in the Borders applying for UC.

4.10 The combination of reduced funding, increased workload due to the Welfare Reform changes and uncertainty about the future of the service is resulting in increased staff turnover within the Service.

4.11 An action plan (Appendix 2) has been created by Customer Advice & Support Service to agree the tasks to be carried out to remove the risks detailed above.

4.12 Audit Scotland is satisfied that the proposed actions will make a positive Contribution to the continuous improvement in the Council's Housing Benefit service, and therefore no further scrutiny is planned. However, they have asked for an update on our proposed actions and in respect of speed of processing and accuracy performance by 31 May 2018.

5 IMPLICATIONS

5.1 Financial

Any financial implications as a result of the actions in the plan will be met from existing budgets.

5.2 Risk and Mitigations

The Audit of Housing Benefit – Risk Assessment Report identifies 6 risks to continuous improvement to help Councils improve their benefit service. The Council accepts the finding of the risk assessment and has provided an action plan in order to mitigate these risks."

5.3 Equalities

The Audit of Housing Benefit – Risk Assessment Report identifies 6 risks to continuous improvement to help Councils improve their benefit service. The Council accepts the finding of the risk assessment and has provided an action plan in order to mitigate these risks.

5.4 Acting Sustainably

There are no effects on any economic, social or environmental of doing or not doing what is proposed.

5.5 Carbon Management

There will be no impact on the Council's carbon emissions of doing or not doing what is proposed.

5.6 Changes to Scheme of Administration or Scheme of Delegation

There are no changes to be made.

6 CONSULTATION

6.1 The Chief Financial Officer, the Monitoring Officer, the Chief Legal Officer, the Chief Officer Audit and Risk, the Service Director HR and the Clerk to the Council have been consulted and any comments received have been incorporated into the final report.

6.2 The Chief Executive, Executive Directors (Rob Dickson and Phillip Barr), Service Director Customer & Communities and Communications & Marketing have also been consulted.

Approved by

Jenni Craig **Signature ………………………………..**
Service Director Customer & Communities

Author(s)

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Clare Easson	Development Officer – 01835 824000 ext 8294

Background Papers:

Previous Minute Reference: Public Minutes (3232)

Note – You can get this document on tape, in Braille, large print and various computer formats by contacting the address below. Clare Easson can also give information on other language translations as well as providing additional copies.

Contact us at Customer Advice and Support Development Team, Council Headquarters, Newtown St Boswells, TD6 0AS

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Appendix 1

Scottish Borders Council

Audit of housing benefit

Risk assessment report

AUDIT SCOTLAND

Prepared for Scottish Borders Council
September 2017

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. We help the Auditor General for Scotland and the Accounts Commission check that organisations spending public money use it properly, efficiently and effectively.

Contents

Introduction

1. This risk assessment was completed as part of Audit Scotland's housing benefit (HB) risk assessment programme. It does not represent a full audit of Scottish Borders Council's benefit service.

2. The Local Government in Scotland Act 2003 introduced new statutory duties relating to Best Value and Community Planning. The key objective of the risk assessment is to determine the extent to which the benefit service is meeting its obligations to achieve continuous improvement in all its activities.

3. Specifically, the risk assessment considers the effectiveness of the benefit service in meeting national and local priorities, business planning and reporting, and delivering outcomes.

4. Information for this risk assessment was gathered from a range of sources including:
   - the self-assessment and supporting evidence provided by the council
   - Department for Work and Pensions (DWP) indicators, and other performance measures
   - a review of internal and external audit reports
   - discussions with the appointed external auditor
   - discussions with senior officers in the council during our site visit in July 2017.

Executive summary

5. A risk assessment was previously carried out on Scottish Borders Council's benefit service in March 2014 when we identified one risk to continuous improvement. This was reported to the Chief Executive in June 2014 and, as only one risk had been identified, the council was not required to provide an action plan.

6. In addressing this risk, the council has contributed positively to the delivery of the benefit service by developing an annual programme of interventions activity, which focuses on customers that are considered to be at high-risk of having an unreported change event.

7. Although the council demonstrates awareness of what constitutes an effective, efficient and secure benefit service, there are six new risks arising from this risk assessment, and in order to ensure continuous improvement, the council needs to address these risks. These include:
   - the average time taken to process new claims and change events has declined significantly in quarter one of 2017/18, and there is a significant risk that based on current resource levels, the benefit service will be unable to maintain or improve on previous performance
   - the performance of the benefit service is not being formally reported to the relevant Council monitoring committee and, in addition, performance in respect of the recovery of all benefit overpayments is not being formally reported to senior management out with the

Customer and Advice Service, or to elected Members as part of the Council's performance management framework

- performance in respect of the accuracy of claims declined significantly in 2016/17.

Background

8. Since our previous visit, there have been some significant changes within the benefit service, including a restructure in 2014 which merged front and back office operations to provide a more efficient and streamlined service. A further restructure, which commenced in 2016, will bring the benefit service into the newly formed Homelessness and Financial Support Division of the Customer and Communities Directorate in preparation for full implementation of Universal Credit in March 2018. We were advised that the current restructure is due to be completed by September 2017.

9. In addition, there has been a significant turnover of staff within the service over the last two years with almost 50% of assessors currently in post having less than two years' experience. These changes have provided significant challenges for the service, in particular around workloads and the training of new staff, which has impacted on new claims processing times and the accuracy of claims. The impact of these changes is discussed in more detail under *Speed of processing* and *Accuracy*.

10. As a relatively small council with a caseload of approximately 7,700 claims and 10.7 full-time equivalent (FTE) benefit assessors, resource management is an important aspect of the service. Since 2013/14, the council has used a number of strategies to manage its resources through peak workloads, the recruitment and training of new staff, and preparing for the full implementation of Universal Credit in March 2018.

11. This has included the use of external agencies to manage the recovery of HB overpayments where the customer is no longer in receipt of HB, and to carry out benefit assessment work. In addition, regular overtime was carried out in 2016/17 and, in order to transfer knowledge and facilitate cross working, the service has made good use of secondments into the benefit service, and from the benefit service to other areas of the council.

12. In respect of claims processing, since October 2015, the benefit service has utilised the services of an external agency for significant periods at approximately 40 hours per week, and from April 2017 to September 2017, has increased the use of this resource to 70 hours per week, which equates to an extra two FTE staff for the service.

13. Despite this, we were advised that benefit assessors are carrying out a number of other activities in addition to core processing duties. These include dealing with Housing Benefit Matching Service (HBMS) referrals, the output from the National Fraud Initiative (NFI) data matching exercise, and dealing with overpayments where the customer is no longer in receipt of HB.

14. It is of concern therefore that, at a time when the service is utilising additional resources to manage the service, claims processing performance has declined from an average of 24 days for new claims, and an average of six days for change events in 2016/17, to an average of 29 days and nine days respectively in the first quarter of 2017/18.

15. This level of performance places the council 28th of 32 councils in Scotland for the average time taken to process new claims, and 18th for the average time taken to process change events, based on the DWP's 2016/17 (Q3) published performance data.

Business planning and reporting

16. An effective business plan provides an opportunity for the council to set out the aims and objectives for each service and should contain key deliverables against which performance is measured, monitored and reported.

17. The *Corporate Plan 2013-2018* details the council's vision to seek the best quality of life for the people in the Scottish Borders, prosperity for businesses, and good health and resilience for communities. It also sets out the standards to which the council aspires to as follows:

- putting customers and staff at the heart of what we do
- being fair, equal and open
- continually improving services
- working with partners and stakeholders
- delivering value for money in the use of resources.

18. At an operational level, the annual *Customer Services Business Plan* is comprehensive and contains the benefit service's key activities and performance indicators. The key performance indicators include the:

- average time to process new claims and change events
- percentage of interventions resulting in a change
- accuracy of benefit claims.

19. However, there are no performance indicators in respect of the service's performance in respect of the recovery of HB overpayments raised and recovered in-year, or in respect of all debt recovery.

20. There is regular reporting of benefit service performance to staff and senior management which provides a level of assurance that the service is operating effectively and efficiently. This includes:

- weekly tele-meetings between the Locality Team Leader (Benefits Lead), Locality Team Leader, and the Benefit Supervisor to discuss work priorities, resourcing, and key issues

- weekly senior management meetings between the Customer Services Manager, Customer Services Operations Manager, and the Lead Officer (Development and Support) to discuss performance and resources
- weekly Customer and Community Management Team meetings to discuss the strategic direction of the service in the context of the council's strategic direction
- monthly 1-2-1 meetings with staff at which individual performance concerns are raised, if appropriate
- quarterly 'all staff' briefings
- six monthly individual 1-2-1 meetings for staff as part of the council's annual Performance Review and Development process.

21. A weekly 'dashboard' is also produced and disseminated to all benefit staff which details work outstanding and claims processing performance. In addition, the council makes good use of an online performance management tool, which is updated monthly with the service's key performance indicators, and is available to view by senior management and elected Members.

Risks to continuous improvement	
1	There is a significant risk that based on current resource levels, the benefit service will be unable to maintain or improve on previous performance.
2	The performance of the benefit service is not being formally reported to the relevant Council monitoring committee and, in addition, performance in respect of the recovery of all benefit overpayments is not being formally reported to senior management out with the Customer and Advice Service, or to elected Members as part of the Council's performance management framework.

Delivering outcomes

22. Effective operational processes and IT systems, along with skilled staff, help benefit services deliver sound performance and continuous improvement. The council has a number of management arrangements in place to support this.

Speed of processing

23. When customers claim benefit, it is a time of financial uncertainty for them and, as such, it is essential that the service has sufficient fully trained and effective benefit processors in place that can make informed decisions on complex benefit claims, and pay benefit promptly.

24. As detailed under *Background,* the benefit service has been through a number of changes since our previous visit in May 2014. Throughout this period, the council has strived to deliver a full benefit service while experiencing significant change, including the recruitment and

training of five new staff over the last two years, two service restructures, and additional workloads.

25. Consequently, claims processing times declined in 2015/16 to an average of 29 days for new claims, and an average of eight days for change events. This level of performance placed the council 28th out of 32 councils in Scotland for the average time to process new claims, and 25th for the average time to process change events, based on the DWP's 2015/16 published performance data.

26. The council took action to address this decline by implementing a number of process improvements, and continuing to work closely with its key stakeholders. These improvements included:

- making good use of the DWPs Automated Transfer to Local Authority Systems (ATLAS) to automate approximately 80% of change events
- implementing an e-Benefits online benefit calculator and claim form
- utilising customer service advisors and administrative staff to carry out general pre-assessment work to allow experienced assessors to focus on claims processing duties
- engaging external agents to provide additional resources to assist in claims processing and HB overpayment recovery activities.

27. In particular, the implementation of e-Benefits has been successful. The council advised us that, as at June 2017, approximately 50% of new claims are being received via e-Benefits and that it is planned to extend this facility to allow customers to report a change event online by the end of the 2017/18 financial year. There are a number of advantages to e-Benefits. These include:

- reducing the number of customers attending council offices
- reducing the costs in respect of the production of claim forms, and associated postage
- having a completed claim form available to benefit assessors within approximately 15 minutes of online completion
- reducing the number of claims received that require assessment, but result in no entitlement, as customers are able to determine if they are entitled to receive any benefit by using the benefit calculator before they commit to completing the claim form.

28. It is recognised, and commendable, that the action taken by the council to address performance resulted in a significant improvement in claims processing times in 2016/17, to an average of 24 days for new claims, and an average of six days for change events. This level of performance placed the council 22nd in Scotland for the average time taken to process new claims, and 5th for the average time taken to process change events, based on the DWP's 2016/17 (Q3) published performance data.

29. However, as detailed under *Background*, despite increasing the number of hours of additional resource provided by an external agency from 40 hours to 70 hours in April 2017, claims processing performance has declined in the first quarter of 2017/18, to an average of 29 days for the time taken to process new claims, and an average of nine days for the time taken to

process change events. This level of performance places the council 28th of 32 councils in Scotland for the average time taken to process new claims, and 18th for the average time taken to process change events, based on the DWP's 2016/17 (Q3) published performance data.

30. Exhibit 1 illustrates the council's current and previous performance.

Exhibit 1: Speed of processing performance (average number of days)

	2014/15	2015/16	2016/17	2017/18 (at 30 Jun)
New claims	23 days	29 days	24 days	29 days
Change events	6 days	8 days	6 days	9 days

Source: Scottish Borders Council & DWP

31. It is acknowledged that the council is continually seeking new ways to improve the service, and we were advised that the service plans to introduce risk-based verification to its claims processing procedures before the end of 2017, and would be utilising the DWPs Wider Use Real Time Information (WuRTI) data from August 2017, both of which the council anticipates will help improve claims processing times.

Risk to continuous improvement	
3	The average time taken to process new claims and change events has declined significantly in quarter one of 2017/18.

Accuracy

32. The accurate and secure administration of HB should be a key priority for every council, and to support this it should have a robust quality assurance framework in place.

33. The council places significant importance on the accuracy of its claims and has a comprehensive management checking process in place to help provide assurance that the customer is receiving the right amount of benefit.

34. To reduce the potential for an overpayment to arise, the majority of management checks are carried out pre-payment. This is considered good practice as it allows the benefit service to correct any errors before a payment has been made.

35. On a daily basis a benefit IT system report is produced which details all claims that have been calculated that day and a sample of claims is selected for a management check, with a focus on claims which have an underpayment, or an overpayment. Once selected, each claim is subject to a comprehensive check, which covers up to 96 aspects of the claim, where appropriate. This includes checks on:

- claim keying

- household details
- earned income
- capital
- rent
- overpayments.

36. When an error is found, the assessor receives an e-mailed copy of the checklist and is asked to correct the error and update the claim history record before returning the checklist to the Benefit Supervisor, who would ensure that the appropriate corrective action had been taken.

37. The outcomes from accuracy checks are recorded electronically on a detailed spreadsheet, which is summarised and analysed to identify any trends or patterns of error, and is used to address any specific remedial training needs, for example, the development of guidance notes and desk aids.

38. We were advised that there is a 100% check of the work of new staff by experienced benefit assessors, which is gradually reduced as accuracy levels improve. In addition, there is a 100% check of all payments over £500 to ensure the accuracy of the payment before it is issued.

39. There is also a weekly check of the DWPs Single Housing Benefit Extract (SHBE) data by the Benefit Supervisor to correct any claims where an incorrect effective date might have been used, and to identify claims that have taken over 40 days to process so that appropriate action can be taken.

40. Although the benefit service does not have a dedicated training officer, there is a clear support and training process. Instruction notes and desk aids have been produced to help and guide staff through the assessment process. For example, new process maps have recently been developed to assist staff in determining the correct start date of a new claim.

41. In addition, the council has developed a knowledge database for its customer service advisors, and an HB Info database for benefit assessors that are regularly updated, which help to assist staff by providing answers to frequently asked questions, and links to guidance on relevant subjects.

42. Exhibit 2 illustrates the council’s current and previous accuracy performance.

Exhibit 2: Financial accuracy performance

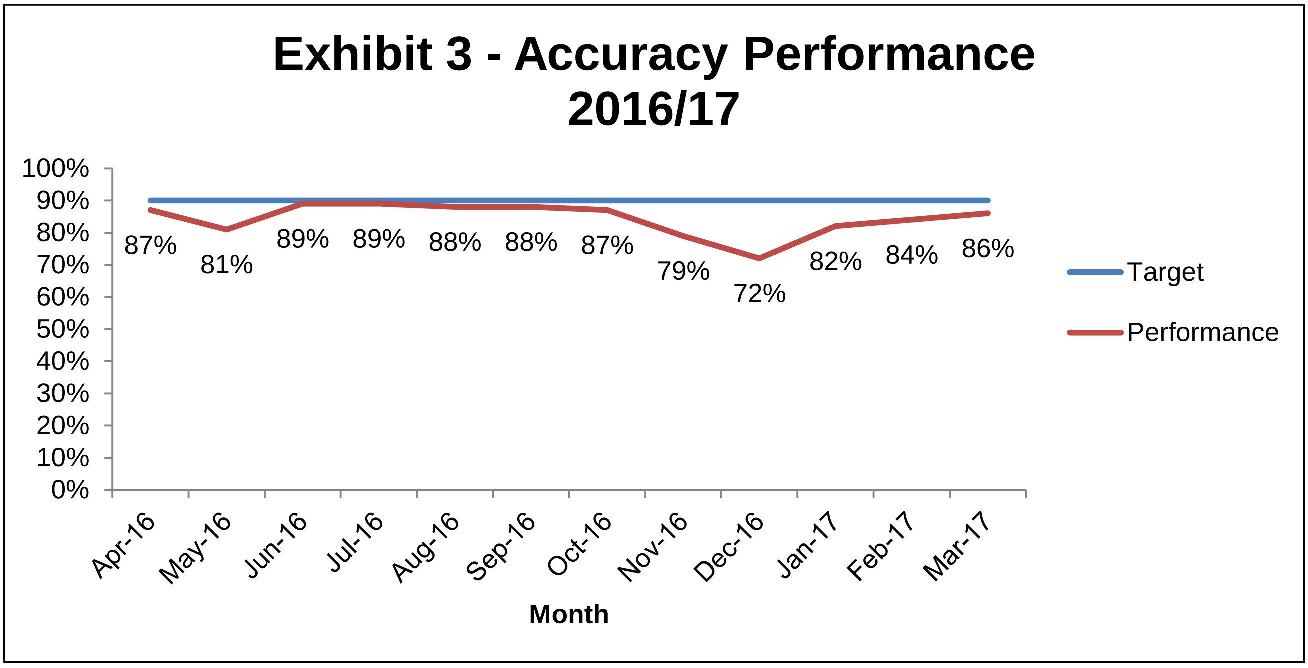
	Target	Achieved
2014/15	94%	94%
2015/16	94%	94%
2016/17	90%	82%
2017/18 (at 31 May)	90%	92%

Source: Scottish Borders Council

43. Although the council met its accuracy target in 2014/15 and 2015/16, there was a significant decline in accuracy performance in 2016/17. We were advised that the main reason for the decline was the number of new staff in the service that were receiving a 100% check of their work and, consequently, more errors were identified.

44. When we analysed the 2016/17 monthly accuracy data and removed the two assessors that accounted for 57% of all checks carried out during the year, we found that the council's accuracy rate had increased to 89%. However, this level of performance was still below the relatively low target of 90%, and below performance in 2015/16, at 94%

45. In addition, when new and inexperienced staff join the service we would expect to see the benefit service's accuracy rate improve over time, as these staff gain experience, and the service learns from analysis of its accuracy checks. However, as detailed in exhibit 3 below, the council's accuracy rate fluctuated throughout the year, and in the last five months, performance was below what was reported in April 2016.



Source: Scottish Borders Council

46. It is acknowledged that the council had identified accuracy as an area for improvement, and had developed an accuracy action plan to address performance. At the time of the site visit in July 2017, we found that eight of the 11 planned actions had been completed. These actions included:

- completing a year-end analysis of all assessor errors
- considering new checklists and desk aids
- providing refresher training to staff, as appropriate
- having a regular quiz for assessors to test their knowledge.

47. Although the council's accuracy performance declined in 2016/17, it is acknowledged that, at 31 May 2017, performance had improvement considerably to 92%. However, it was established that there are a number of other management checks and activities that are carried out which are not recorded as part of the general management checking process. For example:

- outcomes from checks of payments over £500
- reconsiderations and appeals, where the outcome resulted in a change to the customer's benefit
- checks on overpayments
- results from interventions activities.

Risks to continuous improvement	
4	Accuracy performance declined significantly in 2016/17.
5	The benefit service is not formally recording the outcomes from all of its management checking activities, and is therefore unable to report on the accuracy of the service as a whole.

Interventions

48. To minimise error in the caseload councils must encourage customers to report any change events on time, and have a robust intervention programme to identify un-notified change events, and take appropriate corrective action.

49. The council is very proactive in its efforts to educate customers of the need to report a change event. This includes providing a reminder on all benefit letters, examples on the council website of types of changes that should be notified, information on how to report a change by e-mail, telephone and mail, and a change event form that can be downloaded for offline completion.

50. In addition, the council has taken action to raise awareness of the need to report a change event by utilising social media, advertising on its contact centre television screens, the local radio station, and in local magazines and tenant newsletters. We were also advised that customers that have provided a mobile phone number are contacted periodically by text message to remind them of the need to report any change in their circumstances.

51. In 2015/16 and 2016/17, the council was successful in achieving approximately £39,000 from the DWP's Fraud and Error Reduction Incentive Scheme (FERIS) which provides council's with funding to target intervention activities at specific areas of its caseload that are considered to be at high-risk of having an unreported change event.

52. In 2016/17, the council used this funding to provide additional resource to the benefit service to carry out a programme of postal interventions. For example:

- February - customers with declared childcare costs

- April - customers in receipt of statutory sick pay for six months
- June - customers in receipt of a private pension
- July - customers that have stocks and shares
- August - customers with capital in excess of £15,000
- November - customers of pension age with capital in excess of £9,000.

53. In 2016/17, the council was one of a few councils in Scotland that received payments from the DWP by exceeding its quarterly baseline threshold for identifying change events in quarters one, three, and four. In addition, year on year since 2015/16, the benefit service has identified an increasing number of unreported change events from its interventions activities, which demonstrates effective targeting. This is commendable.

54. The outcomes from interventions are recorded on the benefit IT system as an increase, decrease, or no change to benefit, and exhibit 4 below summarises these outcomes.

Exhibit 4: Interventions performance

	No. of interventions completed	No. of changes identified	%
2014/15	1,457	673	46%
2015/16	1,718	1,001	58%
2016/17	2,475	1,607	65%
2017/18 (at 31 May)	254	159	63%

Source: Scottish Borders Council

55. In addition to its proactive interventions activities, the benefit service makes good use of the benefit IT system diary facility to produce reports that highlight claims where future change events are expected, or known, which could affect the customer's benefit entitlement, for example, a significant birthday, or an increase in earnings.

56. The council also actively participates in the DWP's Housing Benefit Matching Service (HBMS), Audit Scotland's National Fraud Initiative (NFI), and more recently the DWP's Real Time Information (RTI) and optional RTI data matching services, which all help to identify possible unreported change events that require further investigation.

57. We were also advised that the service will have access to the DWP's WuRTI data from August 2017, which will provide real time earnings details for customers and help the benefit service to process these changes timeously, and reduce overpayments.

58. The service has also opted into to the DWP's Right Benefit Initiative and has received approximately £25,000 in funding, which we were advised would be used to outsource some benefit processing activities to free up time for staff training and quality improvement initiatives.

Risk to continuous improvement	
6	Although interventions outcomes are recorded, the level of detail is not sufficient to allow the council to determine the effectiveness of its approach in financial terms, or the effectiveness of each monthly intervention campaign, which could help ensure that future activity is informed, risk-based, and cost effective.

59. As mentioned in the *Executive summary* we identified one risk to continuous improvement during our previous risk assessment in that, with the introduction of ATLAS, the number of interventions now required had reduced. The service needed to review and revise its interventions approach to ensure that it was effectively focused on identifying unreported changes and error in its caseload.

60. We consider that this risk has been addressed, as the council has been effectively targeting its caseload and evaluates its activity based on the number of changes identified against the number of interventions completed to give a more accurate assessment of performance.

Overpayments

61. To protect public funds, councils should take appropriate steps to ensure that overpayments are minimised and that when they do occur they are correctly classified and rigorously recovered.

62. The new *HB Overpayment and Debt Recovery Policy* developed in August 2016, and approved by council in March 2017 is comprehensive and sets out the council's approach and principles in the recovery of debt, details the types of overpayments that can be recovered, and the methods of recovery that are available.

63. Where an overpayment is not being recovered from on-going benefit, the council makes use of all available recovery options including:

- issuing an invoice when the customer is no longer in receipt of benefit
- utilising the DWP's Payment Deduction Programme to automate the recovery of HB overpayments from Universal Credit, where appropriate
- offsetting an overpayment using a credit on a customer's rent account
- using the DWP's Customer Information System to trace customers who are no longer resident within the local authority area
- using a Direct Earnings Attachment (DEA) when the customer is in employment
- working with Sheriff Officers, where all other available recovery options have been exhausted.

64. In order to minimise benefit overpayments, the council prioritises change events that could lead to an overpayment, uses benefit IT system reports to predict changes, and reminds customers wherever possible of the need to report any changes. We were also advised that a claim would be suspended immediately if there was any doubt over entitlement.

65. This proactive approach has helped minimise the number of local authority (LA) and administrative error overpayments that can arise as a result of processing delays. This is particularly important as a council can lose subsidy where its LA/administrative error rate exceeds 0.48% of all HB payments made. In 2015/16 and 2016/17, the council has performed well against this target by recording an LA/administrative error rate of 0.21% and 0.28% respectively.

66. The council does not have a dedicated HB overpayment recovery officer, and in 2014/15 entered into a 12-month contract with an external agent to pursue HB sundry debtor accounts on its behalf. At the end of the contract in July 2015, the work was brought back in-house. However, we were advised that, from July 2015 until January 2017, HB sundry debtor accounts, where the customer had not responded to the council's correspondence, had not been actively pursued, as there were insufficient resources available during this time.

67. As detailed earlier under *Performance reporting* there are no documented targets for in-year, or all debt recovery, and therefore there is limited reporting of overpayment recovery performance. However, we were advised that the Customer Service Manager sets an annual cash collection target for the benefit service, as part of the budget planning process and that performance against this target is monitored and reported monthly to the Service Director.

68. We were also advised that this target had always been achieved and that, in respect of 2017/18, a cash collection target of £235,000 had been set, which includes a separate target of £25,000 for claims where a Direct Earnings Arrestment is in place.

69. Exhibit 5 illustrates the council's current and previous HB overpayment recovery performance.

Exhibit 5: Overpayment levels and recovery performance

	2014/15	2015/16	2016/17	2017/18 (at 31 May)
Total overpayments c/f	£1,057,745	£1,516,832	£2,747,605	£2,898,712
Total overpayments raised in-year	£1,016,218	£1,199,214	£1,033,061	£214,638
HB debt recovered	£747,164	£1,209,644	£1,035,401	£211,006
HB written off	£33,544	£4,918	£137,387	£253
% of in-year debt recovered	74%	101%	100%	98%
% of total HB debt recovered	36%	45%	27%	7%

Source: Scottish Borders Council

70. As a result of historical system issues, the council has not had confidence in the overpayment information provided by the benefit IT system, and consequently there is limited assurance that the data provided to Audit Scotland as part of the evidence to support its self-assessment is an accurate reflection of actual performance.

71. As detailed above, there is a difference of approximately £1.25million between the closing balance in 2015/16 and the opening balance in 2016/17, which we have been unable to reconcile. However, following discussions with council officers we have been assured that reported performance from 2016/17, to date, is accurate and that overpayment amounts reconcile in-month, and at year end.

72. Since March 2016, the council has taken positive action to identify the reasons for the year-end reconciliation issues and has continued to take corrective action to make the overpayment recovery process more robust by:

- developing a new *HB Overpayment and Debt Recovery Policy,* which sets the operational framework for the recovery of HB overpayments
- engaging with a benefit IT system consultant in an attempt to identify and resolve the issues around the year-end reporting of HB overpayment recovery performance
- carrying out data cleansing activities, including the identification of cases where overpayment recovery action can recommence. For example, in August 2017, the council plans to use the DWPs WuRTI data to recommence recovery action in cases where the customer is in employment, and has not previously responded to the council's correspondence.

73. It is recognised that the council is aware that this is an area that requires improvement and that, since this work came back in-house in July 2015, the actions already taken, and planned actions going forward will help to deliver the required improvements.

Appendix 2

Scottish Borders Council - Risk Assessment – Action Plan – October 2017

Risk Number	Description of risk	Action to be taken	Responsibility		List of tasks to be carried out to remove risks	By when
			Lead officer	Others		
1	There is a significant risk that based on current resource levels, the benefit service will be unable to maintain or improve on previous performance.	Maximise use of existing resource including revised processing and managerial arrangements resulting from the service restructure.	Lead Officer Benefits	Financial Support & Inclusion Team Leader and Supervisors	Responsibility for Discretionary Housing Payments and Scottish Welfare Fund will move from the current management area to the Financial Support and Inclusion Team. This will reduce non HB/CTR work in the team. These areas will become separate streams of work.	15/11/17
		Extend use of contracted services	Lead Officer Benefits	Customer Advice & Support Manager Homelessness & Financial Support Manager	Increase resource from existing contract. Add new provider - requires CGI to add Virtual Private Network access urgently	31/12/17
		Focus overtime working	Lead Officer Benefits	Customer Advice & Support Manager Homelessness & Financial Support Manager	Staff overtime when required will be focussed on specific tasks to ensure it provides value for money	31/12/17
2	The performance of the benefit service is not being formally reported to the relevant Council monitoring committee and, in addition, performance in respect of the recovery of all benefit overpayments is not being formally reported to senior management out with the Customer and Advice Service, or to elected members as part of the Council's performance management framework.	Present monthly summary, quarterly and bi-annual detail reports	Lead Officer Benefits	Customer Advice & Support Manager Homelessness & Financial Support Manager	Present a monthly summary report to the Service Director commencing November 2017. Present a quarterly report to the Service Director and Chief Financial Officer commencing January 2018.	31/01/18

Risk Number	Description of risk	Action to be taken	Responsibility: Lead officer	Responsibility: Others	List of task to be carried out to remove risks	By when
					Present a bi-annual report to relevant performance committee January 2018	
3	The average time taken to process new claims and change events has declined significantly in quarter one of 2017/18.	Actions from risk 1 and 2	Lead Officer Benefits		Improve processing procedures and focus overtime working	15/11/17
		Introduce Risk Based Verification (RBV)	Lead Officer Benefits	Customer Advice & Support Development Team Customer Advice & Support Systems and Support Officer	Implement go live for RBV software and procedures	31/01/18
		Increase take up of online application	Lead Officer Benefits	Customer Advice & Support Development Team	Promote take via radio etc adverts, Staff to encourage take-up through supporting customers on-line Introduce offline app for Registered Social Landlords and Homelessness Team	31/12/17
4	Accuracy performance declined significantly in 2016/17.	Consolidate staff and end permanent lone working	Lead Officer Benefits	Customer Advice & Support Manager Homelessness and Financial Support Manager	Find sites to accommodate staffing levels (maximum 2 sites)	15/11//17
		Increase post notification checks	Lead Officer Benefits	Benefit Supervisors	Increase the numbers of post notification checks	15/11/17

Risk Number	Description of risk	Action to be taken	Responsibility		List of task to be carried out to remove risks	By when
			Lead officer	Others		
		Create a greater emphasis in one to ones on accuracy levels	Lead Officer Benefits	Benefit Supervisors	New line management arrangements under new structure	15/11/17
		Review desk aids, instruction notes and training notes	Lead Officer Benefits	Benefit Supervisors	Provide focussed instructions on 13 week protection, earned income, reg 9 and Persons From Abroad	31/12/17
		Six monthly review of Assessor PN check errors	Lead Officer Benefits	Benefit Supervisors	Review error trends and areas for individual or team development	15/11/17
5	The benefit service is not formally recording the outcomes from all of its management checking activities, and is therefore unable to report on the accuracy of the service as a whole.	Extend the existing speadsheet for analysis of errors found outwith formal pre or post notification checks	Lead Officer Benefits	Benefit Supervisors	Record all examples of errors or bad practice from enquiries, appeals, Single Housing Benefit Extract (SHBE) report checks and over £500 payments checks. Include these checks within existing analysis	15/11/17
6	Although interventions outcomes are recorded, the level of detail is not sufficient to allow the council to determine the effectiveness of its approach in financial terms, or the effectiveness of each monthly intervention campaign, which could help ensure that future activity is informed, risk-based, and cost effective.	Increase the analytical detail against claim adjustments codes to drill down to change reasons and amounts derived	Lead Officer Benefits	Customer Advice & Support Development Team Customer Advice & Support Systems and Support Officer	Confirm with Customer Advice & Support Systems Team whether additional codes can be included for reporting purposes in the benefits system to allow identification of review types. Contact other local authorities Agree review code types, Create suitable reports. Agree the reporting regime	31/12/17

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Scottish Borders COUNCIL

TREASURY MANAGEMENT STRATEGY 2018/19

Report by Chief Financial Officer

AUDIT AND SCRUTINY COMMITTEE

15 January 2018

1 PURPOSE AND SUMMARY

1.1 **This report is to enable the Audit and Scrutiny Committee to undertake their scrutiny role in relation to the Treasury Management activities of the Council. It presents the proposed Treasury Management Strategy for 2018/19 for consideration prior to Council approval.**

1.2 The Treasury Management Strategy is the framework which ensures that the Council operates within prudent, affordable limits in compliance with the CIPFA Code.

1.3 The Strategy for 2018/19 to be submitted to Council on 08 February 2018 is included in this report at Appendix 1 and reflects the impact of the Administration's draft Financial Plans for 2018/19 onwards on the prudential and treasury indicators for the Council.

2 RECOMMENDATIONS

2.1 **It is recommended that the Committee considers whether to make any comments or recommendations on the draft Treasury Management Strategy for 2018/19 prior to presentation to the Council for approval.**

3 BACKGROUND

3.1 The Audit and Scrutiny Committee is responsible for scrutinising the Treasury Management Strategy in line with recommended practice set out in the CIPFA (Chartered Institute of Public Finance and Accountancy) Code (i.e. Treasury Management in the Public Services: Code of Practice and Cross-sectorial Guidance Notes).

4 TREASURY MANAGEMENT STRATEGY 2018/19

4.1 Appendix 1 contains the draft Treasury Management Strategy for 2018/19 for consideration by the Audit and Scrutiny Committee.

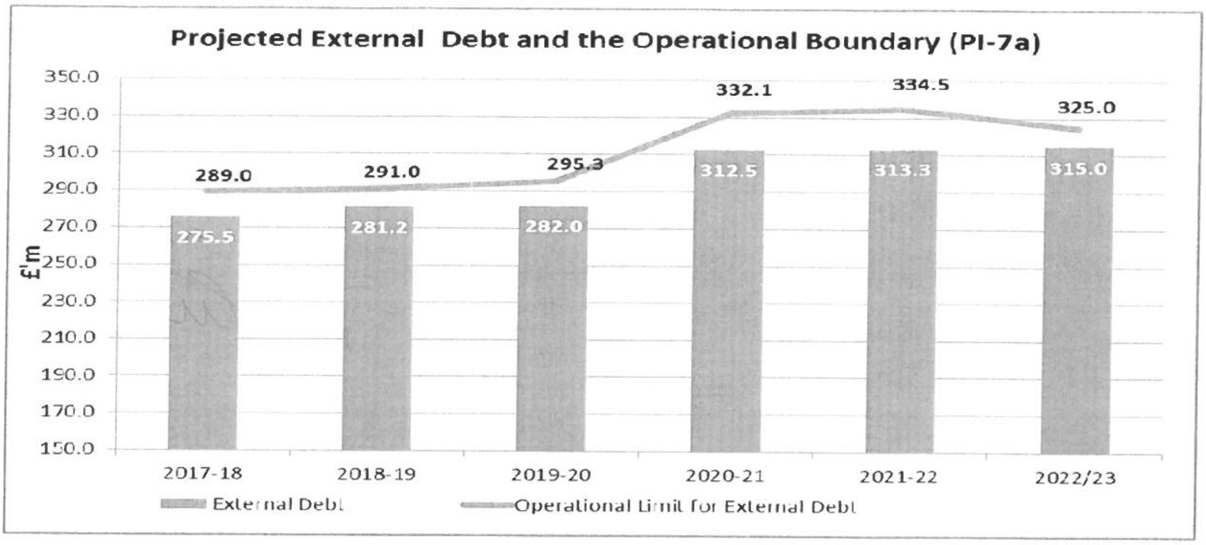
4.2 This is based on the Administration's current draft Financial Capital Plans for 2018/19 to 2027/28, yet to be published and as such is subject to change as these plans will not be presented to Council for approval until 09 February 2017. The final version of this report which will be reported to Council will included a 20 year loans charges projection based on assumed future capital expenditure.

4.3 Appendix 1, Annex A contains a summary of the proposed indicators within the strategy. The significant changes from the 2017/18 strategy are:

(a) Increase in the Capital Financing Requirement (CFR) for 2018/19 due to the inclusion of the new Kelso High School in the Councils Fixed Assets in 2017/18. Also impacting on the CFR movement is the anticipated capital borrowing requirements associated with the re-phasing of projects from 2017/18 into 2018/19 and future years as well as movements in the scheduled debt amortisation projections for the year.

(b) Increase in the Authorised Limit in 2018/19 associated with debt following the completion of Kelso High School and the resulting Long Term liability and the increase in external borrowing resulting from the capital plan.

4.4 The table below shows the "Operational Boundary" against the anticipated levels of external borrowing. The external borrowing levels should not normally exceed the operational boundary limit, defined by the Prudential Framework. The gap between these two elements as seen in the table, consistently shows that the Council maintains an "under-borrowed" position for current and next 5 years. The step change in 2020-21 represents the planned Jedburgh Intergenerational Campus becoming a Council asset, along with the associated long term liability.



5 IMPLICATIONS

5.1 Financial

There are no additional financial implications in relation to this report its content specifically relating to the financing and investment activities of the Council.

5.2 Risk and Mitigations

The key purpose of presenting the Strategy to Audit and Scrutiny Committee scrutiny is to ensure that the members are satisfied with this element of the risk management framework for the treasury management function within the Council. The risks to delivering the Strategy have been identified within the Strategy itself at Appendix 1. Controls and mitigating actions have been implemented, monitored and reviewed in line with the Council's Risk Management Policy. The Strategy provides the parameters and guidance for the investment and borrowing decisions for the Council.

5.3 Equalities

It is anticipated that there are no adverse equality implications arising from the proposals in this report.

5.4 Acting Sustainably

There are no direct economic, social or environmental issues with this report which would affect the Council's sustainability policy.

5.5 Carbon Management

There are no direct issues or consequences arising from this report which would affect the Council's carbon management.

5.6 Rural Proofing

There are no direct issues or consequences arising from this report which would affect the Council's rural proofing policy.

5.7 Changes to Scheme of Administration or Scheme of Delegation

No changes to the Scheme of Administration or Scheme of Delegation are required as a result of this report.

6 CONSULTATION

6.1 The Monitoring Officer, the Chief Legal Officer, the Chief Officer Audit and Risk, the Service Director HR and the Clerk to the Council have been consulted and any comments received have been incorporated into the final report.

Approved by

David Robertson
Chief Financial Officer

Signature ....

Author(s)

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Background Papers:
Previous Minute Reference:

Note – You can get this document on tape, in Braille, large print and various computer formats by contacting the address below. The Capital and Investment Team can also give information on other language translations as well as providing additional copies.

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APPENDIX 1

SCOTTISH BORDERS COUNCIL

TREASURY MANAGEMENT STRATEGY (incorporating the Annual Investment Strategy) 2018/19

Finance
Chief Executive Department
Version 1

CONTENTS

1 Purpose and Scope

1.1 The Council is required to receive and approve, as a minimum, three main reports on treasury activity each year, which incorporate a variety of policies, estimated and actual figures.

a) Treasury Management Strategy 2018/19 (this report).
This report is the most important of the three reports and covers:

- The capital plans of the Council (including prudential indicators);
- The treasury management strategy (how the investments and borrowings are organised), including treasury indicators, and
- An investment strategy (investment options and limits applied).

b) Mid Year Treasury Management Report – This will update members with the progress of the capital position, amending prudential indicators as necessary, and assess whether the actual treasury strategy is adhering to the approved strategy, or whether any policies require revision.

c) Annual Treasury Report - This provides details of a selection of actual prudential and treasury indicators compared to the estimates within the strategy and the performance of actual treasury operations.

1.2 Scrutiny
These reports are required to be adequately scrutinised by committee before being recommended to the Council. This role is undertaken by the **Audit and Srutiny Committee**.

1.3 The treasury management issues covered by this report are:

Capital Issues
- the capital plans and associated prudential indicators

Treasury management issues
- the current treasury position
- treasury indicators which will 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

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

1.5 The increased Member consideration of treasury management matters and the need to ensure that officers dealing with treasury management are trained and kept up to date requires a suitable training process for Members and officers. This Council will address this important issue by:

a) Elected Members
- Working with members of the Audit Committee to identify their training needs
- Working with Link Asset Services to identify appropriate training provision for elected members

b) Officers dealing with treasury management matters will have the option of various levels of training including:

- Treasury courses run by the Council's advisers
- Attendance at CIPFA treasury management training events
- Attendance at the CIPFA Scottish Treasury Management Forum and information exchanged via the Treasury Management Forum network
- On the job training in line with the approved Treasury Management Practices (TMPs).

1.6 Treasury Management Consultants

The Council uses Link Asset Services as its external treasury management advisors.

The Council recognises that responsibility for treasury management decisions remains with the Council at all times and will ensure that it does not rely solely upon information and advice from its external service providers.

It also recognises however that there is value in employing external providers of treasury management services in order to gain 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.

1.7 The Treasury Management Strategy covers the treasury management activities for the Council (including any subsidiary organisations), the cash managed by the Council on behalf of the Scottish Borders Council Pension Fund, the Common Good and Trust Funds.

2 Background

2.1 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.

2.2 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.

2.3 The Prudential and Treasury Indicators (summarised in **Annex A**) consider the affordability and impact of capital expenditure decisions, and set out the Council's overall capital framework. These Indicators have been developed in line with both the Prudential and Treasury Codes. The treasury service considers the effective funding of these decisions. Together they form part of the process which ensures the Council meets its balanced budget requirement under the Local Government Finance Act 1992. The Treasury Management Strategy therefore forms an integral part of the Council's overall Financial Strategy covering both its revenue and capital budgets.

2.4 CIPFA defines treasury management 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 The Capital Prudential Indicators 2017/18 – 2021/22

The Council's Financial Strategy sets out financial resource and management parameters within which it will deliver its Corporate Vision and Priorities. The Financial Strategy brings together various elements of financial policy and strategy, including the Treasury Management Strategy, and establishes the financial planning framework for the Council in terms of Revenue Expenditure and Capital Investment. The output from this framework is the Council's Financial Plan, approved annually in February, presenting the financial proposals for delivering its services and objectives.

The Financial Strategy establishes that the Financial Principles underpinning the planning for the Council's future service delivery are to:

(i) Raise the funds required by the Council to meet approved service levels in the most effective manner;
(ii) Manage the effective deployment of those funds in line with the Council's corporate objectives and priorities; and
(iii) Provide stability in resource planning and service delivery as expressed through Corporate and Business Plans and the Revenue and Capital Financial Plan.

In order to adhere to these Principles, the Financial Strategy states that the Council will adopt Financial Objectives to:

"ensure capital borrowing is within prudential borrowing limits and sustainable in the longer term. In this regard it is important to recognise the capital investment decisions taken now have long term borrowing implications and these have the potential to place a significant burden on future tax payers".

The draft revenue budget sets loans charges associated with capital borrowing over the next 5 years at £20.2m.

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

3.1 Capital Expenditure (Prudential Indicator PI-1)

a) This prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this planning cycle. The Capital Financial Plan for 2018/19 – 2027/28 includes the following capital expenditure forecasts for the first five years:

Capital Expenditure (PI-1)	**Estimate**					
£m	**2017/18**	**2018/19**	**2019/20**	**2020/21**	**2021/22**	**2022/23**
Assets & Infrastructure	28.0	19.4	26.7	30.6	22.1	23.0
Other Corporate Services	4.1	0.6	0.5	0.6	0.7	0.5
Children & Young People	16.9	7.5	5.8	4.4	6.1	5.9
Culture & Sport	2.0	0.9	1.4	2.1	0.5	0.6
Economic Dev. & Corp. Services	8.3	6.4	3.9	0.6	0.6	0.6
Emergency & Unplanned Schemes	0	0.3	0.3	0.3	0.3	0.3
Health & Social Care	0.4	0.2	0.3	0.2	0.3	0.1
Planned Programming Adjustments	(2.9)	1.0	1.9	0	0	0
Total	**56.8**	**36.3**	**40.8**	**38.8**	**30.6**	**31.0**

It should be noted that expenditure associated with the construction of the proposed Jedburgh inter-generational school campus is not included in the above as it is funded as a 'Design, Build, Fund & Maintain (DBFM) model and therefore out-with the Councils capital programme.

3.2 Other Relevant Expenditure

a) The Council anticipates to have additional expenditure which, for the purposes of the Treasury and Prudential Indicators, will be treated as capital expenditure. This expenditure relates to initiatives where the Council has applied, or is planning to apply, for a Consent to Borrow from the Scottish Government. The key area not included in paragraph 3.1 is borrowing to lend in respect of an affordable house building programme in partnership with the Scottish Futures Trust (Bridge Homes LLP) The estimated amounts are as follows:

Other Relevant Expenditure £m	Estimate					
	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Bridge Homes LLP (Affordable house building programme)	0.4	0.4	-	-	-	-

3.3 Capital Financing Assumptions

a) 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 financing need.

Capital Expenditure £m	Estimate					
	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Capital Expenditure – per plan	56.8	36.3	40.8	38.8	30.6	31.0
Other Relevant Expenditure	0.4	0.4	-	-	-	-
Total Expenditure	**57.2**	**36.7**	**40.8**	**38.8**	**30.6**	**31.0**
Financed by:						
Capital receipts	1.9	2.3	1.8	0.3	-	-
CFCR	0.4	0.4	-	-	-	-
Developer Contributions	1.7	0.7	0.7	0.1	0.1	1.1
Govt. General Capital Grants	15.4	15.4	15.4	14.0	14.0	14.0
Govt. Specific Capital Grants	8.1	2.1	10.1	13.4	6.9	0.6
Other Grants & Contributions	2.2	3.2	2.6	1.6	-	-
Plant & Vehicle Fund	1.3	2.0	2.4	2.0	2.0	2.0
Net financing need for the year	**25.8**	**10.2**	**3.3**	**6.5**	**6.8**	**12.8**

3.4 The Council's Borrowing Need (the Capital Financing Requirement – Prudential Indicator PI-2)

a) 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 identified above, which has not immediately been paid for (e.g. via grants), 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.

b) The CFR includes any other long term liabilities (e.g. PPP 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 had £73.1m of liabilities relating to such schemes within the 2017/18 long term liabilities figure which includes £21.3m relating to funding arrangements for the construction of a new High School in Kelso. The CFR increases by a further £33.0m in 2020/21 as a result of the Jedburgh campus mentioned above.

c) The Council is asked to approve the CFR projections below:

Capital Financing Requirement (PI-2) £m	Actual	Estimate					
	16/17	17/18	18/19	19/20	20/21	21/22	22/23
Total CFR (PI-2) *	**286.6**	**324.1**	**323.8**	**317.0**	**346.9**	**343.9**	**347.0**

Movement in CFR represented by:							
Net financing need for the year (above)		25.8	10.2	3.3	6.5	6.8	12.8
Less scheduled debt amortisation and other financing movements		11.7	(10.5)	(10.1)	(23.4)	(9.8)	(9.7)
Movement in CFR		**37.5**	**(0.3)**	**(6.8)**	**29.9**	**(3.0)**	**3.1**

* *The CFR for this calculation includes capital expenditure to 31 March of each financial year.*

The CFR variance between 2017/18 and 2018/19 is driven by the shift in the net financing need for the year as detailed in the table in section 3.3 and also by the inclusion of Kelso High School. The main driver for the variance is a reduced Capital Programme with a consequential reduction in required borrowing.

4 Treasury Management Strategy

The capital expenditure plans set out in Section 3 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 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 appropriate borrowing facilities. The strategy covers the relevant treasury/prudential indicators, the current and projected debt positions and the annual investment strategy.

4.1 Current Portfolio Position

a) The Council's treasury portfolio position at 31 March 2018, with forward projections, is 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.

as at 31 March £m	Estimate				
	2017/18	**2018/19**	**2019/20**	**2020/21**	**2021/22**
Borrowing **Other Long Term Liabilities**	202.4 73.1	210.4 70.8	213.5 68.5	213.5 99.0	216.8 96.5
Total Gross Borrowing (Prudential Indicator PI-5)	**275.5**	**281.2**	**282.0**	**312.5**	**313.3**
CFR – the borrowing need *	**317.0**	**346.9**	**343.9**	**347.0**	**347.0**
(Under) / Over Borrowing (Prudential Indicator PI-6)	**(41.5)**	**(65.7)**	**(61.9)**	**(34.5)**	**(33.7)**

** The CFR for this calculation includes the current and two future years projected capital expenditure see 4.1b)*

b) 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 (PI-6) is that the Council needs to ensure that its gross debt figure (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 2016/17 and following two financial years. This allows some flexibility for limited borrowing for future years, but ensures that borrowing in advance of need is not undertaken for revenue purposes.

c) The Council has complied with this prudential indicator in the current year and no difficulties are currently envisaged for the long term future. This view takes into account current commitments, existing plans, and the proposals in the Financial Plans for 2018/19.

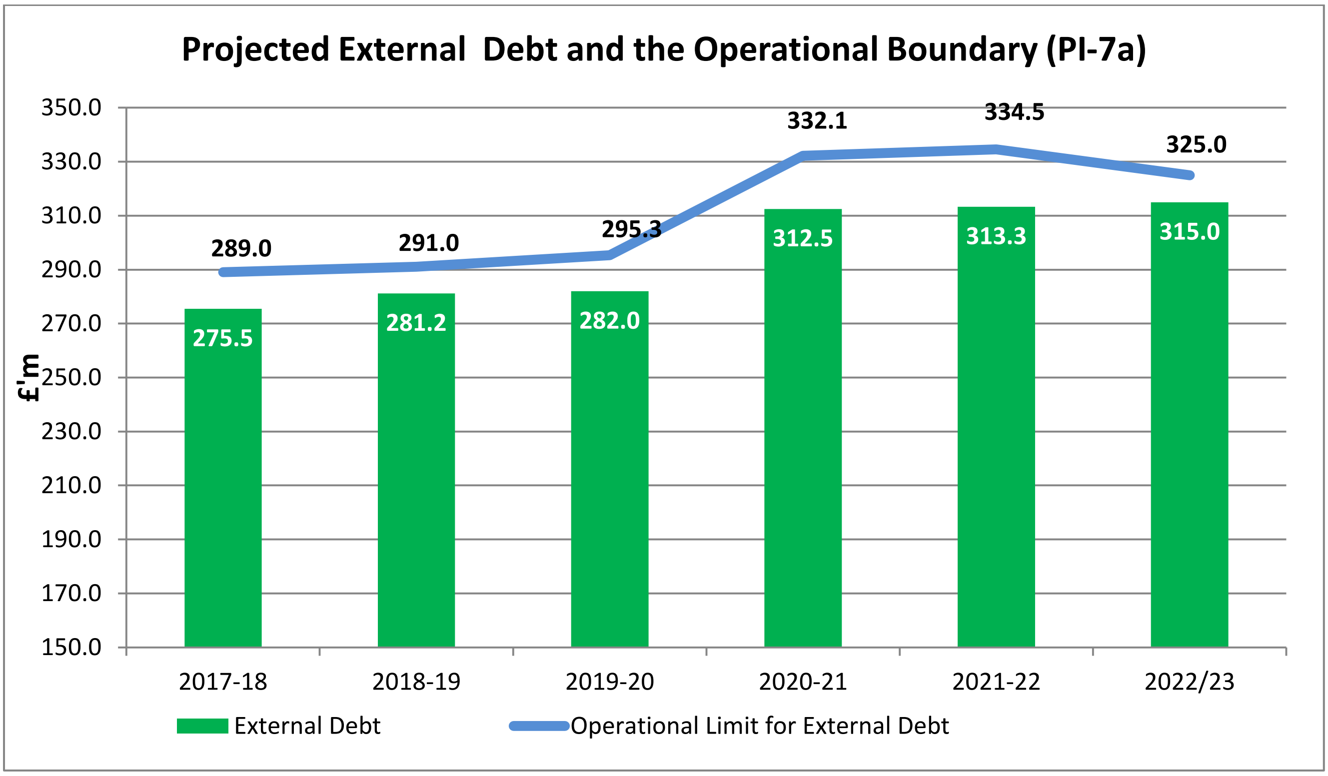
4.2 Treasury Indicators: Limits to Borrowing Activity

The Operational Boundary (Prudential Indicator PI-7)

a) This is the limit which external borrowing 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.

Operational boundary £m	Estimate					
	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Total Operational Boundary (PI-7a)	**289.0**	**291.0**	**295.3**	**332.1**	**334.5**	**325.0**
Less: Other long term liabilities	(73.1)	(70.8)	(68.5)	(99.0)	(96.5)	(94.0)
Operational Boundary exc. Other Long Term Liabilities (PI-7b)	**215.9**	**220.2**	**226.8**	**233.2**	**238.1**	**231.0**

b) The following chart shows how the current and projected Operational Borrowing limit compare with the anticipated levels of actual debt.



The Authorised Limit for External Debt (Prudential Indicator PI-8)

c) 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 borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

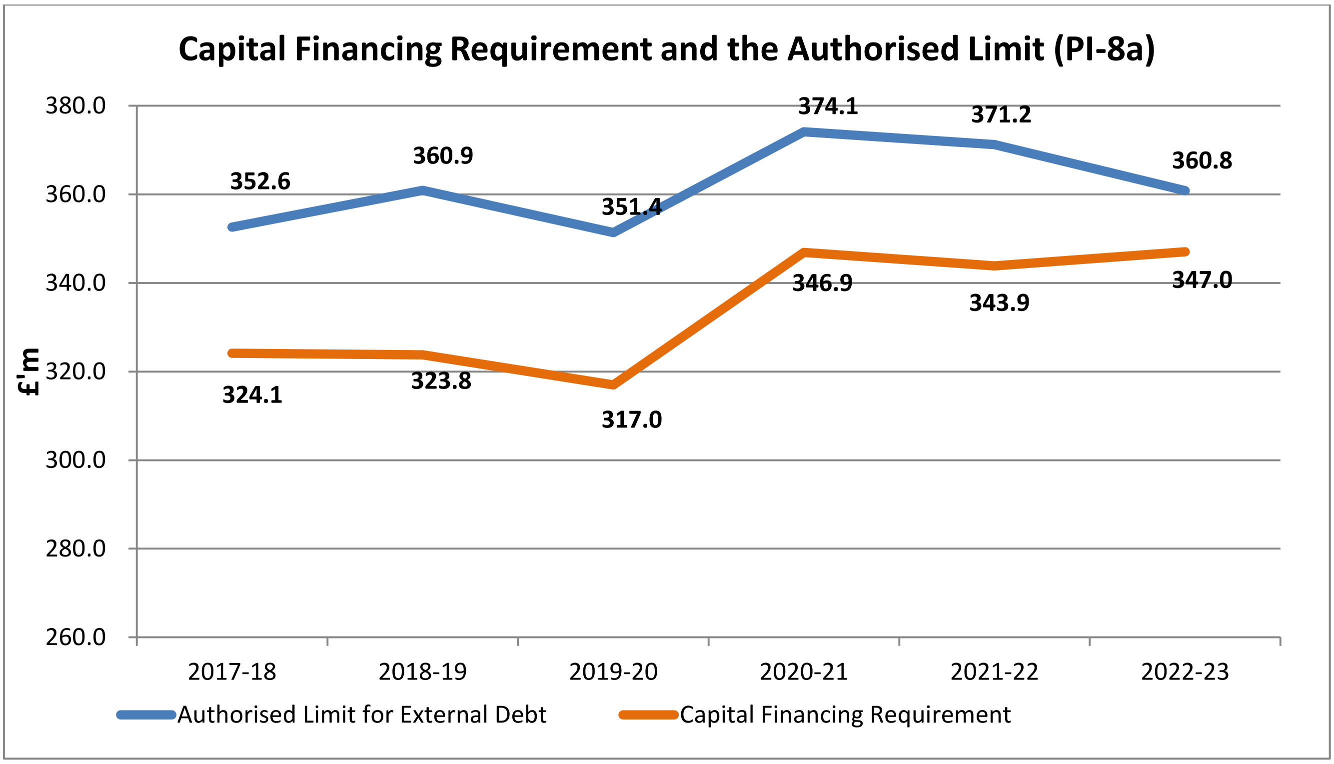
d) This is the statutory limit (Affordable Capital Expenditure Limit) determined under section 35(1) of the Local Government in Scotland Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised.

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

Authorised Limit	Estimate

£m	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Total Authorised Limit (PI-8a)	**352.6**	**360.9**	**351.4**	**374.1**	**371.2**	**360.8**
Less: Other long term liabilities	(73.1)	(70.8)	(68.5)	(99.0)	(96.5)	(94.0)
Authorised Limit exc. Other Long-Term Liabilities (PI-8b)	**279.5**	**290.1**	**282.9**	**275.1**	**274.8**	**266.8**

f) The chart on the below shows how the current and projected Capital Financing Requirement compares the Authorised Limit for External Debt



4.3 Prospects for Interest Rates

a) 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 gives our central view.

	Dec-17	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%	0.50%	0.50%	0.50%	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%
5yr PWLB Rate	1.50%	1.60%	1.60%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.10%	2.10%	2.20%	2.30%	2.30%
10yr PWLB View	2.10%	2.20%	2.30%	2.40%	2.40%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%
25yr PWLB View	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB Rate	2.50%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%

b) As expected, the Monetary Policy Committee (MPC) delivered a 0.25% increase in Bank Rate at its meeting on 2 November. This removed the emergency cut in August 2016 after the EU referendum. The MPC also gave forward guidance that they expected to increase Bank rate only twice more by 0.25% by 2020 to end at 1.00%. The Link Asset Services forecast as above includes increases in Bank Rate of 0.25% in November 2018, November 2019 and August 2020.

c) 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. The sharp rise in bond yields since the US Presidential election in November 2016 has called into question whether the previous trend may go into reverse, especially now the Fed. has taken 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.

d) 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.

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

f) 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.

g) Downside risks to current forecasts for UK gilt yields and PWLB rates currently include.

- Bank of England monetary policy 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.
- The result of the October 2017 Austrian general election is likely to result in a strongly anti-immigrant coalition government. In addition, the new Czech prime minister is expected to be Andrej Babis who is 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

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

- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- UK inflation returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.
- The Fed causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal of Quantitative Easing, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.

i) 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 increased sharply after the result of the general election in June and then also after the September MPC meeting when financial markets reacted by accelerating their expectations for the timing of Bank Rate increases. Apart from that, there has been little general trend in rates during the current financial year. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in the future when 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.

j) **Annex C** contains a more comprehensive Economic Background narrative from Link Asset Services.

4.4 Borrowing Strategy

a) 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.

b) Against this background and the risks within the economic forecast, caution will be adopted with the 2018/19 treasury operations. The Chief Financial Officer 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 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.

c) Any decisions will be reported to Members at the next available opportunity.

4.5 Policy on borrowing in advance of need

a) Borrowing in advance is defined as any borrowing undertaken by the local authority which will result in the total external debt of the local authority exceeding the capital financing requirement (CFR) of the local authority for the following twelve month period. This twelve month period is on a rolling twelve month basis.

b) The Council will not borrow more than or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed.

c) 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.

d) The Chief Financial Officer has the authority to borrow in advance of need under delegated power where, for instance, a sharp rise in interest rates is expected, and so borrowing early at fixed interest rates will be economically beneficial or meet budgetary constraints. The Chief Financial Officer will adopt a cautious approach to any such borrowing and a business case to support the decision making process must consider:

- the benefits of borrowing in advance,
- the risks created by additional levels of borrowing and investment, and
- how far in advance it is reasonable to borrow considering the risks identified

e) Any such advance borrowing should be reported through the mid-year or annual Treasury Management reporting mechanism.

4.6 Debt Rescheduling

a) 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).

b) 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).

c) 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.

d) All rescheduling will be reported to the **Executive** at the earliest meeting following its action.

5 Investment Strategy

5.1 Investment Objectives and Policy

a) The Council's investment policy has regard to the Scottish Government's Investment (Scotland) Regulations (and accompanying Finance Circular) and the 2011 revised CIPFA Treasury Management in the Public Services Code of Practice and Cross Sectorial Guidance Notes ("the CIPFA TM Code").

b) The Council's primary investment objectives are as follows, in order of importance:

(i) The safeguarding or **security** of the re-payment of principal and interest of investments on a timely basis; and
(ii) The **liquidity** of its investments
(iii) The **returns on investments** that can be realised

The Council will therefore aim to achieve the optimum return on its investments corresponding with proper levels of security and liquidity. The risk appetite of this Council is low in order to give priority to security of its investments.

c) 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.

d) 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.

e) 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.

f) Investment instruments identified for use in the financial year are listed in Annex D. Counterparty limits will be as set through the Council's treasury management practices.

5.2 Council Permitted Investments

The proposed criteria for permitted investments are shown in appendices xx and xx for approval.

5.3 Creditworthiness Policy

a) 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
- Credit Default Swaps (CDS) spreads to give early warning of likely changes in credit ratings
- sovereign ratings to select counterparties from only the most creditworthy countries

b) 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:

Creditworthiness Colour Banding	**Maximum Investment Duration**
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 (ie don't invest)

Y	Pi1	Pi2	P	B	O	R	G	N/C
1	1.25	1.5	2	3	4	5	6	7
Up to 5yrs	Up to 5yrs	Up to 5yrs	Up to 2yrs	Up to 1yr	Up to 1yr	Up to 6mths	Up to 100days	No Colour

c) 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.

d) 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.

e) 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 a creditworthiness service provided by Link Asset Services.

- 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.

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

5.4 Country and Sector Considerations

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

Country Limits

b) If the institution is non-UK, then the country in which it is domiciled must have a minimum Sovereign long term rating of AAA.

c) No more than **10%** will be placed with any non-UK country at any time.

Institutional Sector Limits

d) 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. The Council may also use the UK Government including in the form of gilts and the Debt Management Account Deposit Facility (DMADF).

e) Limits will be applied to the overall amount lent out to any one sector at any one time in order to limit sector specific exposure risk, as follows:

UK Building Societies	**£25 m**
Banks	**£35 m**
UK Local Authorities	**£40 m**
UK Government Debt Management Office	**£unlimited**
UK Gilts and Treasury Bills	**£20 m**
Institutions covered by Government Guarantee	**£10 m**
Part Nationalised Banks	**£35 m**
Money Market Funds (AAA)	**£20 m**

These limits will be monitored regularly for appropriateness.

Group Limits

g) Limits will be applied to the overall amount lent out to institutions within the same group at any one time in order to limit group specific exposure risk, as follows, and subject to the parent company appearing on Capita Asset Services' creditworthiness list:

Group of Banks **£10m**

Council's Own Banker

h) The Council's own banker (Bank of Scotland – part of Lloyds) will be maintained on the Council's counterparty list in situations where rating changes may mean this is below the above criteria. This is to allow the Council to continue to operate normal current account banking facilities and overnight and short-term investment facilities. However, in the event that the rating does change below the criteria, officers will review the situation carefully and identify any appropriate action required to manage the risk that this change creates for the Council.

5.5 Individual Institution Monetary Limits

a) The monetary limits for institutions on the Council's Counterparty List are as follows:

	Money Limit
UK Building Societies	£5m
Banks	£5m

UK Local Authorities (i)	£40m
UK Government Debt Management Office	Unlimited
UK Gilts & Treasury Bills	£20m
Government Guaranteed Institutions	£2m
AAA rated Money Market Funds	£5m
Council's Own Banker (ii)	£5m

(i) No individual limit will be applied on lending to a UK local authority, other than it must not exceed the relevant sector limit of £40m.

(ii) Further to Sections 5.4 and 5.5, in the event that the rating of the Council's own banker falls below the criteria, the time limit on money deposited with the bank will be reduced to an overnight basis.

b) As mentioned earlier, the treasury function manages the funds of the Council, any subsidiary organisations, the Pension Fund and the Common Good and Trust Funds. When applying the limits set out in the table above, these limits will apply to the cumulative investment with an institution from the Council, the Pension Fund and the Common Good Funds and Trust Funds.

5.6 Types of Investments

a) For institutions on the approved counterparty list, investments will be restricted to safer instruments (such as deposits). Currently this involves the use of money market funds, the DMADF and institutions with higher credit ratings than the minimum permissible rating outlined in the investment strategy, as well as the Council's own bank.

b) Where appropriate, investments will be made through approved brokers. The current list of approved brokers comprises:

- ICAP Securities Limited
- Sterling International Brokers Limited
- Tradition (UK) Limited

5.7 Investment Strategy and bank rate projections

In-house funds

a) 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

b) Bank Rate is forecast to stay flat at 0.50% until quarter 4, 2018 and not to rise above 1.25% by quarter 1, 2021. Bank rate forecasts for financial year-ends (March) are:

2017/2018	0.50%
2018/2019	0.75%
2019/2020	1.00%
2020/2021	1.25%

c) 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

2017/2018	0.40%
2018/2019	0.60%

2019/2020	0.90%
2020/2021	1.25%

d) 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.

Investment Treasury Indicator and Limit (Treasury Indicator TI-5)

e) Total principal funds invested for greater than 365 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of investment, and are based n the availability of funds after each year end.

The Council is asked to approve the treasury indicator and limit:

Maximum principal sums invested > 364 days (TI-5)					
£m	**2016/17**	**2017/18**	**2018/19**	**2019/20**	**2020/21**
Principal sums invested > 364 days	20%	20%	20%	20%	20%

f) For positive cash balances and in order to maintain liquidity, the Council will seek to use overnight investment accounts, short term (< 1 month) notice accounts, money market funds and short-dated deposits (overnight to three months).

5.8 Investment Risk Benchmarking

These benchmarks are simple guides to maximum risk, so they may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is that officers will monitor the current and trend position and amend the operational strategy to manage risk as conditions change. Any breach of the benchmarks will be reported, with supporting reasons in the mid-year or Annual Report.
Security - The Council's maximum security risk benchmark for the current portfolio, when compared to these historic default tables, is.

a) Security

The Council's **maximum** security risk benchmark for the current portfolio, when compared to historic default tables, is:

0.04% historic risk of default when compared to the whole portfolio.

b) Liquidity

In respect of this area the Council seeks to maintain:

- Bank Overdraft: £250,000
- Liquid short term deposits of at least £3,000,000 available with a week's notice.
- Weighted Average Life benchmark is **expected to be 0.5 years** (equivalent to an weighted average life of 6 months), with a **maximum of 1.00 years**

c) Yield

Local measures of yield benchmarks are:

Investments – **Internal returns above the 7 day LIBID rate**

d) At the end of the financial year, the Chief Financial Officer will report on its investment activity as part of the annual treasury report.

6 Performance Indicators

6.1 The CIPFA Code requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking.

6.2 Debt Performance Indicators

(i) 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.

(ii) Average borrowing rate movement year on year

Target is to maintain or reduce the average borrowing rate for the Council versus 2017/18.

6.3 **Investment Risk Benchmark Indicators** for Security, Liquidity and Yield, as set out in paragraph 5.9.

6.4 Loan Charges

a) Loan Charges for 2017/18 are expected to be at or below the Revenue Budget estimate contained in the Council's Financial Plans to be approved in February 2018, which are estimated as follows:

£m	2018/19	2019/20	2020/21	2021/22	2022/23
Interest on Borrowing	12.0	12.0	12.6	13.2	13.0
Investment income	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)
Capital Repayments	8.3	8.3	7.7	7.1	7.3
Total Loan Charges *	**20.2**	**20.2**	**20.2**	**20.2**	**20.2**

**The Loan Charges exclude the capital element of PPP repayments.*

b) The above budget excludes the revenue impact of funding the cost of the NHT and the lending to RSLs and lending in respect of the Council-led house building programme with the Scottish Futures Trust, as these are assumed to be revenue neutral overall.

6.5 The indicators, based on actual performance for the year, will be included in the Treasury Management Annual Report for 2018/19.

ANNEXES

ANNEX A
SUMMARY OF PRUDENTIAL AND TREASURY INDICATORS

Indicator Ref.	Indicator	Page Ref.	2017/18	2018/19	2019/20	2020/21	2021/22
PRUDENTIAL INDICATORS							
Capital Expenditure Indicator							
PI-1	Capital Expenditure Limits (£m)	5	56.8	36.3	40.8	38.8	30.6
PI-2	Capital Financing Requirement (CFR) (£m)	7	324.1	323.8	317.0	346.9	343.9
Affordability Indicator							
PI-3	Ratio of Financing Costs to Net Revenue (inc. PPP repayment costs)	7	8.7%	9.4%	9.6%	9.5%	9.5%
PI-4	Incremental (Saving)/Cost Impact of Capital Investment Decisions on Council Tax	8	(£0.02)	(£0.02)	£(0.03)	(£0.02)	£(0.02)
External Debt Indicators							
PI-5	Actual Debt (£m)	8	275.5	281.2	282.0	312.5	313.3
PI-7a	Operational Boundary (inc. Other Long Term Liabilities) (£m)	9	289.0	291.0	295.3	332.1	334.5
PI-7b	Operational Boundary (exc. Other Long Term Liabilities) (£m)	9	215.9	220.2	226.8	233.2	238.0
PI-8a	Authorised Limit (inc. Other Long Term Liabilities) (£m)	10	352.6	360.9	351.4	374.1	371.2
PI-8b	Authorised Limit (exc. Other Long Term Liabilities) (£m)	10	279.5	290.1	282.9	275.1	274.8
Indicators of Prudence							
PI-6	(Under)/Over Gross Borrowing against the CFR (£m)	9	(41.5)	(65.6)	(61.9)	(34.5)	(33.8)
TREASURY INDICATORS							
TI-1	Upper Limit to Fixed Interest Rates based on Net Debt (£m)	14	289.0	291.0	295.3	332.1	334.5
TI-2	Upper Limit to Variable Interest Rates based on Net Debt (£m)	14	101.2	101.9	103.3	116.3	117.1
TI-3	Maturity Structure of Fixed Interest Rate Borrowing 2018/19	14	**Lower**		**Upper**		
	Under 12 months		0%		20%		
	12 months to 2 years		0%		20%		
	2 years to 5 years		0%		20%		
	5 years to 10 years		0%		20%		
	10 years and above		20%		100%		
TI-4	Maximum Principal Sum invested greater than 364 days	21	20%	20%	20%	20%	20%

Further 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 updated indicators are as follows:

Ratio of financing costs to net revenue stream (Prudential Indicator PI-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 stream.

%	Actual	Estimate				
	16/17	17/18	18/19	19/20	20/21	21/22
Ratio of Financing Costs to Net Revenue Stream (PI-3) *(inc. PPP repayment costs)*	8.5%	8.6%	9.4%	9.6%	9.5%	9.5%

The estimates of financing costs include current commitments and the proposals in the Financial Plans for 2018/19. The movements in the above ratio from 2016/17 onwards reflect a reduction in overall financial resources available to the Council.

Incremental impact of capital investment decisions on council tax (Prudential Indicator PI-4)

This indicator identifies the revenue costs associated the operational three year capital programme detailed in this budget report compared to the Council's existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates, such as the level of Government support, which are not published over a three year period.

£	Estimate				
	2018/19	2019/20	2020/21	2021/22	2022/23
Incremental (Saving)/Cost Impact of Capital Investment Decisions on the Band D Council Tax (PI-4)	(0.02)	(0.02)	(0.03)	(0.02)	(0.02)

Treasury Management Limits on Activity

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

(i) Upper limits on fixed interest rate exposure (Treasury Indicator TI-1)

This identifies a maximum limit for borrowing exposure to fixed interest rates, based on the debt position net of investments.

(ii) Upper limits on variable interest rate exposure (Treasury Indicator TI-2)

This identifies a maximum limit for borrowing exposure to variable interest rates based upon the debt position net of investments.

(iii) Maturity structure of borrowing (Treasury Indicator TI-3)

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.

(iv) The following table highlights the proposed treasury indicators and limits:

£m	2017/18	2018/19	2019/20	2020/21	2022/23
Interest rate exposures					
	Upper	**Upper**	**Upper**	**Upper**	**Upper**

Limits on fixed interest rates based on net debt (TI-1)	289.0	291.0	295.3	299.1	301.5
Limits on variable interest rates based on net debt (TI-2)	101.2	101.9	103.3	104.7	105.5
Maturity Structure of fixed interest rate borrowing 2018/19 (TI-3)					
		Lower		**Upper**	
Under 12 months		0%		20%	
12 months to 2 years		0%		20%	
2 years to 5 years		0%		20%	
5 years to 10 years		0%		20%	
10 years and above		20%		100%	

ANNEX B: INTEREST RATE FORECASTS 2018-21

Link Asset Services Interest Rate View	Dec-17	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%	0.50%	0.50%	0.50%	0.50%	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%
3 Month LIBID	0.40%	0.40%	0.40%	0.40%	0.60%	0.60%	0.60%	0.70%	0.90%	0.90%	1.00%	1.20%	1.20%	1.20%
6 Month LIBID	0.50%	0.50%	0.50%	0.60%	0.80%	0.80%	0.80%	0.90%	1.00%	1.00%	1.10%	1.30%	1.30%	1.40%
12 Month LIBID	0.70%	0.80%	0.80%	0.90%	1.00%	1.00%	1.10%	1.10%	1.30%	1.30%	1.40%	1.50%	1.50%	1.60%
5yr PWLB Rate	1.50%	1.60%	1.60%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.10%	2.10%	2.20%	2.30%	2.30%
10yr PWLB Rate	2.10%	2.20%	2.30%	2.40%	2.40%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%
25yr PWLB Rate	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB Rate	2.50%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%
Bank Rate														
Link Asset Services	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%
Capital Economics	0.50%	0.50%	0.75%	1.00%	1.25%	1.25%	1.50%	1.50%	1.75%	-	-	-	-	-
5yr PWLB Rate														
Link Asset Services	1.50%	1.60%	1.60%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.10%	2.10%	2.20%	2.30%	2.30%
Capital Economics	1.70%	1.90%	2.30%	2.60%	2.90%	2.90%	2.90%	2.90%	2.90%	-	-	-	-	-
10yr PWLB Rate														
Link Asset Services	2.10%	2.20%	2.30%	2.40%	2.40%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%
Capital Economics	2.30%	2.60%	2.80%	3.10%	3.30%	3.30%	3.30%	3.30%	3.30%	-	-	-	-	-
25yr PWLB Rate														
Link Asset Services	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%	3.50%	3.50%	3.60%	3.60%
Capital Economics	2.95%	3.15%	3.45%	3.65%	3.90%	3.90%	3.90%	3.90%	3.90%	-	-	-	-	-
50yr PWLB Rate														
Link Asset Services	2.50%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%
Capital Economics	2.80%	3.10%	3.30%	3.60%	3.80%	3.80%	3.80%	3.80%	3.80%	-	-	-	-	-

Source: Link Asset Services, December 2018

ANNEX C
Economic Background

GLOBAL OUTLOOK. World growth looks to be on an encouraging trend of stronger performance, rising earnings and falling levels of unemployment. In October, 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** and it is particularly notable that **wage inflation** has been subdued despite unemployment falling to historically very low levels in the UK and US. 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 been disappointingly weak**; quarter 1 came in at only +0.3% (+1.8% y/y), quarter 2 was +0.3% (+1.5% y/y) and quarter 3 was +0.4% (+1.5% y/y). The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling after the EU referendum, feeding increases in the cost of imports into the economy. This has caused, in turn, a reduction in consumer disposable income and spending power and so the services sector of the economy, accounting for around 80% of GDP, has seen weak growth as consumers cut back on their expenditure. However, more recently there have been encouraging statistics from the **manufacturing sector** which is seeing strong growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year while robust world growth has also been supportive. However, this sector only accounts for around 10% of GDP so expansion in this sector will have a much more muted effect on the overall GDP growth figure for the UK economy as a whole.

While the Bank of England is expected to give forward guidance to prepare financial markets for gradual changes in policy, the **Monetary Policy Committee, (MPC), meeting of 14 September 2017** managed to shock financial markets and forecasters by suddenly switching to a much more aggressive tone in terms of its words around warning that Bank Rate will need to rise soon. The Bank of England Inflation Reports during 2017 have clearly flagged up that it expected CPI inflation to peak at just under 3% in 2017, before falling back to near to its target rate of 2% in two years' time. The Bank revised its forecast for the peak to just over 3% at the 14 September meeting. (Inflation actually came in at 3.0% in both September and October so that might prove now to be the peak.) This marginal revision in the Bank's forecast can hardly justify why the MPC became so aggressive with its wording; rather, the focus was on an emerging view that with unemployment having already fallen to only 4.3%, the lowest level since 1975, and improvements in productivity being so weak, that **the amount of spare capacity in the economy was significantly diminishing** towards a point at which they now needed to take action. In addition, the MPC took a more tolerant view of low wage inflation as this now looks like a common factor in nearly all western economies as a result of automation and globalisation. However, the Bank was also concerned that the withdrawal of the UK from the EU would effectively lead to a *decrease* in such globalisation pressures in the UK, and so this would cause additional inflationary pressure over the next few years.

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

However, some forecasters are flagging up that they expect growth to accelerate significantly towards the end of 2017 and then into 2018. This view is based primarily on the coming fall in inflation, (as the effect of the effective devaluation of sterling after the EU referendum drops out of the CPI statistics), which will bring to an end the negative impact on consumer spending power. In addition, a strong export performance will compensate for weak services sector growth. If this scenario was indeed to materialise, then the MPC would be likely to accelerate its pace of increases in Bank Rate during 2018 and onwards.

It is also worth noting the **contradiction within the Bank of England** between action in 2016 and in 2017 **by two of its committees**. After the shock result of the EU referendum, the **Monetary Policy Committee (MPC)** voted in August 2016 for emergency action to cut Bank Rate from 0.50% to 0.25%, restarting £70bn of QE purchases, and also providing UK banks with £100bn of cheap financing. The aim of this was to lower borrowing costs, stimulate demand for borrowing and thereby increase expenditure and demand in the economy. The MPC felt this was necessary in order to ward off their expectation that there would be a sharp slowdown in economic growth. Instead, the economy grew robustly, although the Governor of the Bank of England strongly maintained that this was *because* the MPC took that action. However, other commentators regard this emergency action by the MPC as being proven by events to be a mistake. Then in 2017, we had the **Financial Policy Committee (FPC)** of the Bank of England taking action in June and September over its concerns that cheap borrowing rates, and easy availability of consumer credit, had resulted in too rapid a rate of growth in consumer borrowing and in the size of total borrowing, especially of unsecured borrowing. It, therefore, took punitive action to clamp down on the ability of the main banks to extend such credit! Indeed, a PWC report in October 2017 warned that credit card, car and personal loans and student debt will hit the equivalent of an average of £12,500 per household by 2020. However, averages belie wide variations in levels of debt with much higher exposure being biased towards younger people, especially the 25 -34 year old band, reflecting their lower levels of real income and asset ownership.

One key area of risk is that consumers may have become used to cheap rates since 2008 for borrowing, especially for mortgages. It is a major concern that **some consumers may have over extended their borrowing** and have become complacent about interest rates going up after Bank Rate had been unchanged at 0.50% since March 2009 until falling further to 0.25% in August 2016. This is why forward guidance from the Bank of England continues to emphasise slow and gradual increases in Bank Rate in the coming years. However, consumer borrowing is a particularly vulnerable area in terms of the Monetary Policy Committee getting the pace and strength of Bank Rate increases right - without causing a sudden shock to consumer demand, confidence and thereby to the pace of economic growth.

Moreover, while there is so much uncertainty around the Brexit negotiations, consumer confidence, and business confidence to spend on investing, it is far too early to be confident about how the next two to three years will actually pan out.

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 (2.0% y/y), 0.7% in quarter 2 (2.3% y/y) and +0.6% in quarter 3 (2.5% 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 October 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 is following that path again with quarter 1 coming in at only 1.2% but quarter 2 rebounding to 3.1% and quarter 3 coming in at 3.0%. Unemployment in the US has also fallen to the lowest level for many years, reaching 4.1%, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has started on a gradual upswing in rates with four increases in all and three increases since December 2016; and there could be one more rate rise in 2017, which would then lift 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. has been struggling to stimulate consistent significant growth and 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.

Brexit timetable and process

- March 2017: UK government notifies the European Council of its intention to leave under the Treaty on European Union Article 50
- March 2019: initial two-year negotiation period on the terms of exit. In her Florence speech in September 2017, the Prime Minister proposed a two year transitional period after March 2019.
- UK continues as a full EU member until March 2019 with access to the single market and tariff free trade between the EU and UK. Different sectors of the UK economy will leave the single market and tariff free trade at different times during the two year transitional period.
- The UK and EU would attempt to negotiate, among other agreements, a bi-lateral trade agreement over that period.
- The UK would aim for a negotiated agreed withdrawal from the EU, although the UK could also exit without any such agreements in the event of a breakdown of negotiations.
- If the UK exits without an agreed deal with the EU, World Trade Organisation rules and tariffs could apply to trade between the UK and EU - but this is not certain.
- On full exit from the EU: the UK parliament would repeal the 1972 European Communities Act.
- The UK will then no longer participate in matters reserved for EU members, such as changes to the EU's budget, voting allocations and policies.

Annex D
TREASURY MANAGEMENT PRACTICE (TMP1): PERMITTED INVESTMENTS

This Council approves the following forms of investment instrument for use as permitted investments as set out in table 1

Treasury risks
All the investment instruments in tables 1/2 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 the highest, relative, 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. However, it has to be pointed out that while some forms of investment e.g. gilts, CDs, corporate bonds can usually be sold immediately if the need arises, there are two caveats: - a. cash may not be available until a settlement date up to three days after the sale b. there is an implied assumption that markets will not freeze up and so the instrument in question will find a ready buyer.

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. However, some cash rich local authorities may positively want exposure to market risk e.g. those investing in investment instruments with a view to obtaining a long term increase in value.

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. All types of investment instrument have interest rate risk except for the following forms of instrument which are at variable rate of interest (and the linkage for variations is also shown): - (Link Asset Services note – please specify any such instruments should you use them)

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.

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 sufficiently high creditworthiness to be considered for investment purposes. See paragraphs 4.2 and 4.3.

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. All types of investment instruments

Unlimited investments

Regulation 24 states that an investment can be shown in tables 1 / 2 as being 'unlimited' in terms of the maximum amount or percentage of the total portfolio that can be put into that type of investment. However, it also requires that an explanation must be given for using that category. The authority has given the following types of investment an unlimited category: -

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

Annex E
SCHEME OF DELEGATION

(i) Full board/council

- receiving and reviewing reports on treasury management policies, practices and activities;
- approval of annual strategy.

(ii) Boards/committees/council/responsible body

- approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices;
- budget consideration and approval;
- approval of the division of responsibilities;
- receiving and reviewing regular monitoring reports and acting on recommendations;
- approving the selection of external service providers and agreeing terms of appointment.

(iii) Body/person(s) with responsibility for scrutiny

- reviewing the treasury management policy and procedures and making recommendations to the responsible body.

5.8 THE TREASURY MANAGEMENT ROLE OF THE SECTION 95 OFFICER

The S95 (responsible) officer

- Take and/or authorise all operational decisions regarding the Council's investments and borrowing, in accordance with approved Treasury Management Policy and Strategy.
- Responsible for execution and administration of treasury management decisions in accordance with the Council's Treasury Management policy statement and Treasury Management Practice, and if (s)he is a CIPFA member, CIPFA's Standard of Professional Practice on Treasury Management.
- In terms of Treasury Management, from time to time, formulate suitable criteria for assessing and monitoring the credit risk of investment counterparties and construct a lending list defining appropriate limits.
- Borrow, in advance of need, where, for instance, a sharp rise in interest rates is expected, and so borrowing early at fixed interest rates will be economically beneficial or meet budgetary constraints. Adopt a cautious approach to any such borrowing, and a business case to support the decision-making process must consider:
  - the benefits of borrowing in advance,
  - the investment risks created by the existence of investments at the same time as additional borrowing being outstanding; and
  - how far in advance it is reasonable to borrow, considering the risks identified. Any such advance borrowing shall be reported through the mid-year or annual Treasury Management reporting mechanism.
- Take the most appropriate form of borrowing depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast contained in the Treasury Management Strategy.
- Maintain a counterparty list consistent with the Investment Counterparty Selection Criteria and revise the criteria and submit them to Committee for approval as necessary, and in addition, set out the types of investment to be made (Permitted Investments).

Annex F

Credit and Counterparty Risk Management

Permitted Investments, Associated Controls and Limits for Scottish Borders Council, Common Good and Trust Funds and In-house Managed Pension Fund

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good & Trust Fund Limits	Pension Fund In-House Limits
Cash type instruments					
a. Deposits with the Debt Management Account Facility (UK Government) (**Very low risk)**	This is a deposit with the UK Government and as such counterparty and liquidity risk is very low, and there is no risk to value. Deposits can be between overnight and 6 months.	Little mitigating controls required. As this is a UK Government investment the monetary limit is unlimited to allow for a safe haven for investments	£unlimited, maximum 6 months.	£unlimited, maximum 6 months.	£unlimited, maximum 6 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.	£40m, maximum 1 year.	£5m, maximum 1 year.	£40m, maximum 1 year.
c. Money Market Funds (MMFs) **(Very low risk)**	Pooled cash investment vehicle which provides very low counterparty, liquidity and market risk. These will primarily be used as liquidity instruments.	Funds will only be used where the MMFs has a “AAA” rated status from either Fitch, Moody’s or Standard and Poor’s.	£5m per fund/£20m overall	£5m per fund/£20m overall	£5m per fund/£20m overall

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good & Trust Fund Limits	Pension Fund In-House Limits
d. Ultra short dated bond funds **(low risk)**	Pooled cash investment vehicle which provides very low counterparty, liquidity and market risk. These will primarily be used as liquidity instruments.	Funds will only be used where the have a “AAA” rated status from either Fitch, Moody’s or Standard and Poor’s.			
e. Call account deposit accounts with financial institutions (banks and building societies) **(Low risk depending on credit rating)**	These tend to be low risk investments, but will exhibit higher risks than categories (a), (b) and (c) above. Whilst there is no risk to value with these types of investments, liquidity is high and investments can be returned at short notice.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody’s and Standard and Poor’sDay to day investment dealing with this criteria will be further strengthened by use of additional market intelligence.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.
f. 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), (b) and (c) above. Whilst there is no risk to value with these types of investments, liquidity is low and term deposits can only be broken with the agreement of the counterparty, and penalties may apply.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody’s and Standard and Poor’s. Day to day investment dealing with this criteria will be further strengthened by use of additional market intelligence.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good & Trust Fund Limits	Pension Fund In-House Limits
g. Government Gilts and Treasury Bills **(Very low risk)**	These are marketable securities issued by the UK Government and as such counterparty and liquidity risk is very low, although there is potential risk to value arising from an adverse movement in interest rates (no loss if these are held to maturity.	Little counterparty mitigating controls are required, as this is a UK Government investment. The potential for capital loss will be reduced by limiting the maximum monetary and time exposures.	£20m, maximum 1 year.	£5m, maximum 1 year	£20m, maximum 1 year.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good & Trust Fund Limits	Pension Fund In-House Limits
Other types of investments					
a. Investment properties	These are non-service properties which are being held pending disposal or for a longer term rental income stream. These are highly illiquid assets with high risk to value (the potential for property prices to fall or for rental voids).	In larger investment portfolios some small allocation of property based investment may counterbalance/compliment the wider cash portfolio. Property holding will be re-valued regularly and reported annually with gross and net rental streams.	£30m	£25m	N/A
b. Loans to third parties, including soft loans	These are service investments either at market rates of interest or below market rates (soft loans). These types of investments may exhibit credit risk and are likely to be highly illiquid.	Each third party loan requires Member approval and each application is supported by the service rational behind the loan and the likelihood of partial or full default.	£25m	£1m	N/A
c. Loans to a local authority company	These are service investments either at market rates of interest or below market rates (soft loans). These types of investments may exhibit credit risk and are likely to be highly illiquid.	Each loan to a local authority company requires Member approval and each application is supported by the service rational behind the loan and the likelihood of partial or full default.	**£25M**	N/A	N/A
d. National Housing Trust **(Very Low Risk due to Scottish Government Underwriting)**	These are loans to a Special Purpose Vehicle to allow it to purchase new homes under the NHT umbrella. These loans represent either 65% or 70% of the purchase price, the remainder being funded by the developer. The loan is redeemed after a 5 to 10 year period when the properties	Loan redemption arises when the homes are sold. Interest payments are made to the Council by the SPV from rental payments in the intervening period. Both the loan amount and associated interest payments are underwritten by Scottish Government.	£8m	N/A	N/A

	are sold.				
e. Shareholdings in a local authority company	These are service investments which may exhibit market risk and are likely to be highly illiquid.	Each equity investment in a local authority company requires Member approval and each application will be supported by the service rational behind the investment and the likelihood of loss.	**£1m**	N/A	N/A
f. Investment in the Subordinated Debt of projects delivered via the 'HubCo' model **(Very Low Risk)**	These are investments that are exposed to the success or failure of individual projects and are highly illiquid.	The Council and Scottish Government (via the SFT) are participants in and party to the governance and controls within the project structure. As such they are well placed to influence and ensure the successful completion of the project's term. These projects are based on robust business cases with a cashflow from public sector organisations (i.e. low credit risk)	£600,000	N/A	N/A

The Monitoring of Investment Counterparties

The status of counterparties will be monitored regularly. The Council receives credit rating and market information from Link Asset Services, including when ratings change, and counterparties are checked promptly. On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the Director of Finance, and if required new counterparties which meet the criteria will be added to the list.

Use of External Fund Managers

It is the Council's policy to use external fund managers to manage the investment portfolios of the Scottish Borders Council Pension Fund and the pooled investment fund of the Common Good and Trust Funds. This Annex reflects the approved policies around the Common Good and Trust Fund Investment Strategy but specifically excludes, as allowed by regulations, the work undertaken by External Fund Managers in relation to the Scottish Borders Council Pension Fund.

ANNEX G

Credit Ratings

Long and Short Term Credit Ratings

Audit Commission Grading#	**Fitch**		**Moody's**		**Standard and Poor's**	
	Long Term	**Short Term**	**Long Term**	**Short Term**	**Long Term**	**Short Term**
Extremely strong grade	AAA	F1+	Aaa	P-1	AAA	A-1+
Very strong grade	AA+ AA AA-	F1+ F1+ F1+	Aa1 Aa2 Aa3	P-1 P-1 P-1	AA+ AA AA-	A-1+ A-1+ A-1+
Strong grade But susceptible to adverse conditions	A+ A A-	F1+ / F1 F1 F1	A1 A2 A3	P-1 P-1 / P-2 P-1 / P-2	A+ A A	A-1+ / A-1 A-1 A-1 / A-2
Adequate Grade	BBB+ BBB BBB-	F2 F2 / F3 F3	Baa1 Baa2 Baa3	P-2 P-2 / P-3 P-3	BBB+ BBB BBB-	A-2 A-2 / A-3 A-2
Speculative Grade	BB+ BB BB-	B B B	Ba1 Ba2 Ba3	NP * NP NP	BB+ BB BB-	B-1 B-2 B-3
Very Speculative Grade	B+ B B-	B B B	Ba1 Ba2 Ba3	NP NP NP	B+ B B-	- - -
Vulnerable Grade	CCC CCC CCC CC C	C C C C C	Caa1 Caa2 Caa3 - Ca	NP NP NP NP NP	CCC+ CCC CCC- CC C	C C C C C
Defaulting Grade	D	D	C	NP	D	D

for the purpose of standardisation based on Standard and Poor's credit rating definitions.
* NP – Not Prime

Source: Audit Commission adaptation of information from Fitch, Moody's and Standard & Poor's

Viability, Financial Strength and Support Ratings

Continuing regulatory changes in the banking sector designed to see greater stability, lower risk and the removal of expectations of Government financial support should an institution fail. This withdrawal of implied sovereign support is anticipated to have an effect on ratings applied to institutions. This will result in the key rating agency information used to monitor counterparties will be the Short Term and Long Term ratings only. Viability, Financial Strength and Support Ratings previously applied will effectively become redundant. This change does not reflect deterioration in the credit environment but rather a change of method in response to regulatory changes

As a result of these rating agency changes, the credit element of creditworthiness methodology applied by Capita Asset Services will focus solely on the Short and Long Term ratings of an institution. Rating Watch and Outlook information will continue to be assessed where it relates to these categories. This is the same process for Standard & Poor's that has always taken, but a change to the use of Fitch and Moody's ratings. Furthermore, Credit Default Swap prices will continue to be used as an overlay to ratings in our new methodology.

Benchmarking and Monitoring Security, Liquidity and Yield

The consideration and approval of security and liquidity benchmarks are also part of Member reporting. These benchmarks are targets and so may be breached from time to time. Any breach will be reported, with supporting reasons, in the annual treasury report.

Yield
These benchmarks are currently widely used to assess investment performance. Local measures of yield benchmarks are:

- Investments – **Internal returns above the 7 day LIBID rate**

Security and liquidity benchmarks are already intrinsic to the approved treasury strategy through the counterparty selection criteria and some of the prudential indicators. Benchmarks for the cash type investments are below. In the other investment categories, appropriate benchmarks will be used where available.

Liquidity
This is defined as an organisation "having adequate, though not excessive, cash resources, borrowing arrangements, overdrafts or standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives" (CIPFA Treasury Management Code of Practice). In respect of liquidity, the Council seeks to maintain:

- Bank overdraft - £250,000
- Liquid short term deposits of at least £3,000,000 available with a week's notice.

The availability of liquidity in the portfolio can be benchmarked by the monitoring of the Weighted Average Life (WAL) of the portfolio – shorter WAL would generally embody less risk. In this respect, the proposed benchmark to be used is:

- **WAL benchmark is expected to be 0.5 years, with a maximum of 1.00 years**.

Security of the investments
In the context of benchmarking, assessing security is a much more subjective area to assess. Security is currently evidenced by the application of minimum credit quality criteria to investment counterparties, primarily through the use of the Creditworthiness service provided by Capita Asset Services. Whilst this approach embodies security considerations, benchmarking levels of risk is more problematic. One method to benchmark security risk is to assess the historic level of default against the minimum criteria used in the Council's investment strategy.

The Council's maximum security risk benchmark for the whole portfolio, when compared to these historic default tables, is:

- **0.04% historic risk of default when compared to the whole portfolio.**

These benchmarks are embodied in the criteria for selecting cash investment counterparties and these will be monitored and reported to Members in the Annual Treasury Management Report. As this data is collated, trends and analysis will be collected and reported.

GLOSSARY OF TERMS

CIPFA	Chartered Institute of Public Finance and Accountancy
CIPFA Code	Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes
CFR	Capital Financing Requirement is the estimated the level of borrowing or financing needed to fund capital expenditure.
Consent to Borrow	Para 1 (1) of Schedule 3 of the Local Government (Scotland) Act 1975 (the 1975 Act) effectively restricts local authorities to borrowing only for capital expenditure. Under the legislation Scottish Ministers may provide consent for local authorities to borrow for expenditure not covered by this paragraph, where they are satisfied that the expenditure should be met by borrowing.
Gilts	A gilt is a UK Government liability in sterling, issued by HM Treasury and listed on the London Stock Exchange. The term "gilt" or "gilt-edged security" is a reference to the primary characteristic of gilts as an investment: their security. This is a reflection of the fact that the British Government has never failed to make interest or principal payments on gilts as they fall due.
LIBID	London Interbank Bid Rate The rate at which banks bid on Eurocurrency Deposits, being the rate at which a bank is willing to borrow from other banks.
MPC	Monetary Policy Committee
NHT	National Housing Trust initiative undertaken in partnership with the Scottish Futures Trust.
Other Long Term Liabilities	Balance sheet items such as Public Private Partnership (PPP), and leasing arrangements which already include borrowing instruments.
PPP	Public-Private Partnership.
Prudential Indicators	The Prudential Code sets out a basket of indicators (the Prudential Indicators) that must be prepared and used in order to demonstrate that local authorities have fulfilled the objectives of the Prudential Code.
QE	Quantitative Easing
Treasury Indicators	These consist of a number of Treasury Management Indicators that local authorities are expected to 'have regard' to, to demonstrate compliance with the Treasury Management Code of Practice.

You can get this document on tape, in Braille, large print and various computer formats by contacting the address below.

Capital & Investments Team, Corporate Finance, Scottish Borders Council, Council HQ, Newtown St Boswells
01835 824000, t&cteam@scotborders.gov.uk

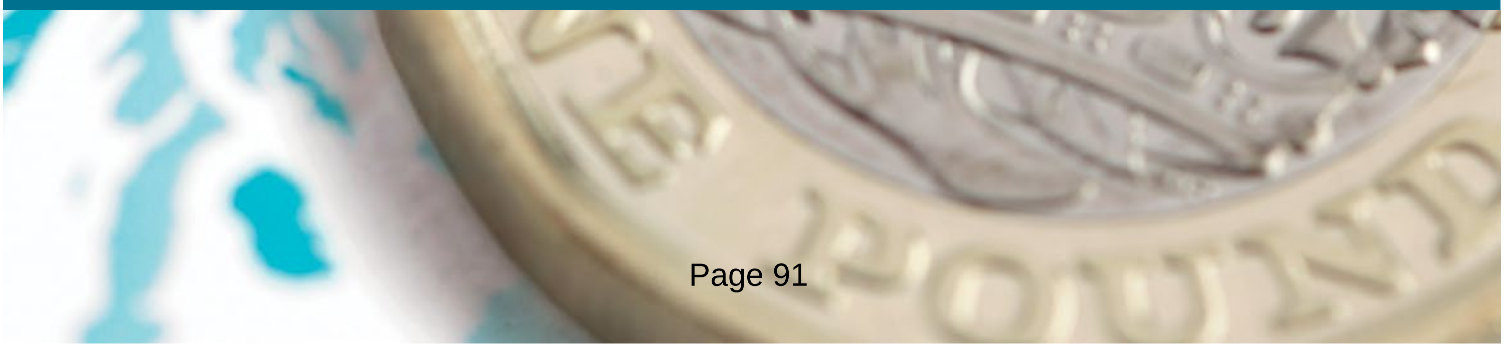
Agenda Item 9

Local government in Scotland

Financial overview 2016/17

ACCOUNTS COMMISSION

Prepared by Audit Scotland
November 2017



The Accounts Commission

The Accounts Commission is the public spending watchdog for local government. We hold councils in Scotland to account and help them improve. We operate impartially and independently of councils and of the Scottish Government, and we meet and report in public.

We expect councils to achieve the highest standards of governance and financial stewardship, and value for money in how they use their resources and provide their services.

Our work includes:

- securing and acting upon the external audit of Scotland's councils and various joint boards and committees
- assessing the performance of councils in relation to Best Value and community planning
- carrying out national performance audits to help councils improve their services
- requiring councils to publish information to help the public assess their performance.

You can find out more about the work of the Accounts Commission on our website: www.audit-scotland.gov.uk/about-us/accounts-commission

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. We help the Auditor General for Scotland and the Accounts Commission check that organisations spending public money use it properly, efficiently and effectively.

Contents

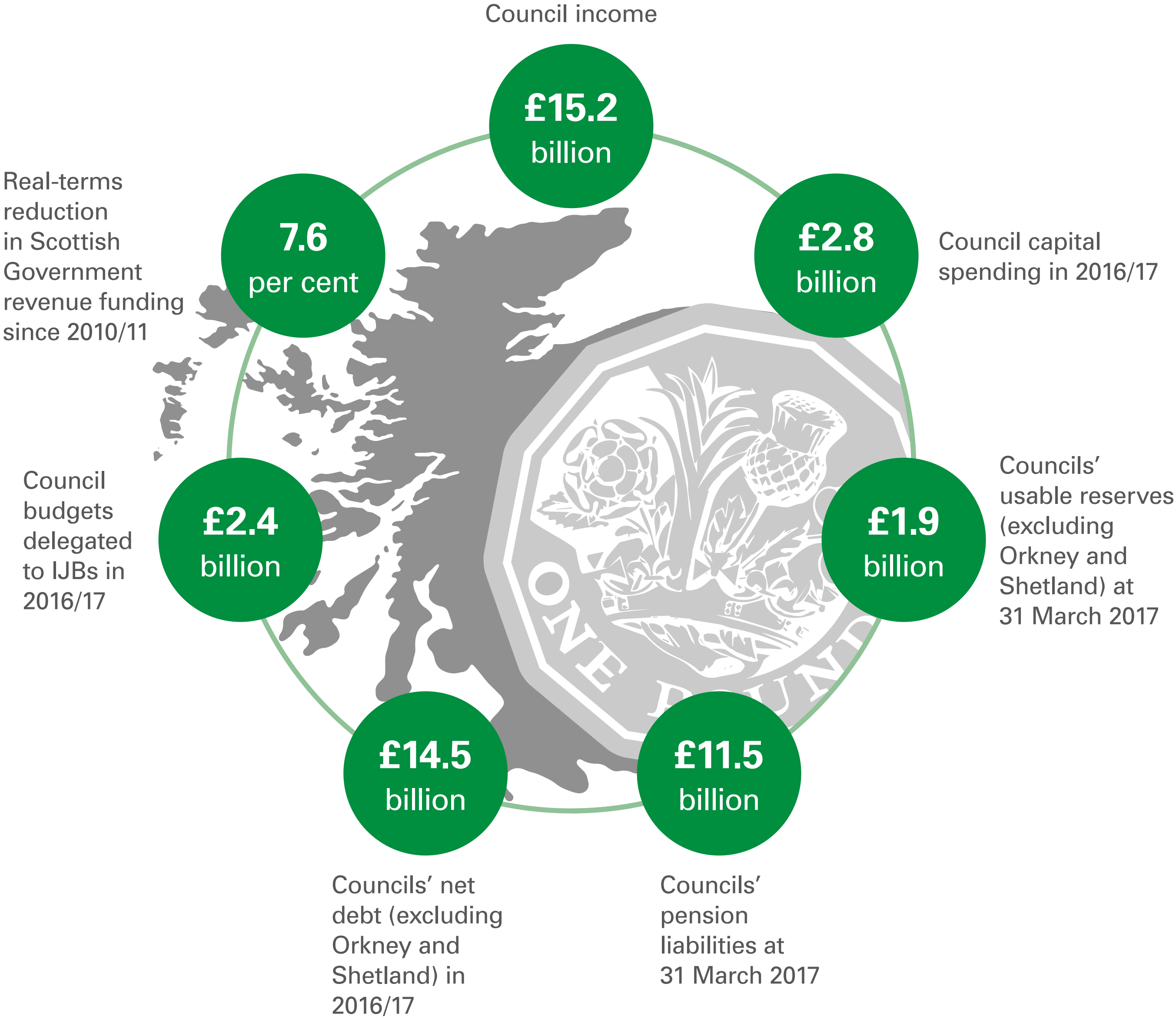
Links

PDF download

Web link

These question mark icons appear throughout this report and represent sample questions for councillors (paragraph 7).

Key facts


Council income
£15.2 billion
£2.8 billion
Council capital spending in 2016/17
£1.9 billion
Councils' usable reserves (excluding Orkney and Shetland) at 31 March 2017
£11.5 billion
Councils' pension liabilities at 31 March 2017
£14.5 billion
Councils' net debt (excluding Orkney and Shetland) in 2016/17
£2.4 billion
Council budgets delegated to IJBs in 2016/17
7.6 per cent
Real-terms reduction in Scottish Government revenue funding since 2010/11

Chair’s introduction

Welcome to the Accounts Commission's 2017 financial overview report for local government.

Last year was the first time that we published a separate financial overview report. In view of the very positive feedback we received from our stakeholders, we have decided to continue publishing two overview reports each year: this one focuses on financial matters, and the other on councils' performance and outcomes, which we plan to publish in April 2018.

Generally, councils face increasing challenges which require flexible responses that balance immediate needs, sound long term planning and limited financial resources. This task is a demanding one for elected members – not least for newly elected members – and I would hope that this overview report and its associated material, including the examples of questions we provide to support scrutiny by councillors, is a useful source of information and guidance.

We live in a rapidly changing public sector landscape, where external issues such as the transfer of further powers to Scotland and the decision to withdraw from the European Union add to an already complex domestic environment. Against this general backdrop the Commission is very aware of the importance of understanding the individual context faced by each council in terms of demand for services and resources available to sustain or develop them.

A major element of this operating environment for councils is the continuing pressure on finances. There was a real terms reduction in councils’ main source of funding from the Scottish Government for 2016/17. This year has seen a further real terms funding reduction, with that trend forecast to continue into future years.

Councils tell us that they are finding the situation more serious than ever, with savings becoming increasingly difficult to identify and achieve. The Commission recognises this, but also recognises that some councils are in a better position to respond than others.

Effective leadership and financial management is becoming increasingly critical and medium-term financial strategies and well thought out savings plans are key to financial resilience and sustainability.

Elected members need to be clear about the potential impact of planned savings on achieving corporate objectives and the subsequent outcomes for citizens. The implications of community empowerment legislation heighten the importance of engaging effectively with communities around local priorities, and working together on options for the best future use of resources in service provision.

The Commission continues to emphasise the importance of Best Value as a comprehensive framework, based on the principle of continuous improvement that encompasses the key features of a high performing and effective council. It is especially relevant in times of tight finances, and we welcome the work being carried out by the Scottish Government, CoSLA, Solace and others, to refresh the Best Value statutory guidance so that it better reflects the current context for local government.

Finally, we welcome that once again the audits of annual accounts from all 32 councils were signed off with no qualifications. This is testament to the hard work amongst council staff, especially those within the finance function, and the good relationships developed by our auditors. There is of course, always room for improvement in financial management, such as in monitoring and reporting of financial matters to both councillors and the wider public. We will continue our interest in this.

Graham Sharp
Chair of Accounts Commission

Summary

Key messages

1 Councils' financial challenges continue to grow. Funding reductions are compounded by increasing costs and demands on services. In response, councils have needed to achieve ambitious savings plans, including around £524 million of savings for 2016/17.

2 Councils are showing signs of increasing financial stress. They are finding it increasingly difficult to identify and deliver savings and more have drawn on reserves than in previous years to fund change programmes and routine service delivery. Some councils risk running out of General Fund reserves within two to three years if they continue to use them at levels planned for 2017/18.

3 Debt increased by £836 million in 2016/17 as councils took advantage of low interest rates to borrow more to invest in larger capital programmes. Councils' debt levels are not currently problematic, but some are becoming concerned about affordability of costs associated with debt within future budgets.

4 Councils' budget-setting processes for 2016/17 were complicated by late confirmation of funding from the Scottish Government and the funding arrangements for integrating health and social care. Councils' expenditure and use of reserves often differed noticeably from that originally planned, indicating the need for budget-setting to become more robust and reliable.

5 All councils received an unqualified audit opinion on their 2016/17 accounts but auditors found that in several councils financial management could be improved. Councils can use their accounts to more clearly explain their financial performance over the whole year to support better scrutiny.

6 The financial outlook for councils continues to be challenging, with the need to deliver savings being increasingly critical to their financial sustainability. As such, robust medium-term financial strategies and effective leadership to deliver them are of increasing importance.

councils are showing signs of increasing financial stress

About this report

1. This report provides a high-level independent analysis of the financial performance of councils during, and their financial position at the end of, 2016/17. It also looks ahead and comments on the financial outlook for councils. It is one of two overview reports that the Accounts Commission publishes each year, complementing a report on councils' performance and outcomes that will be published at the start of the next financial year in April 2018.

2. The report is intended to inform the public and its representatives. It is particularly aimed at councillors and senior council officers, and will be of significant interest to elected members who joined councils for the first time following the May 2017 elections. While the focus of the report is on councils, we also provide some early information about Integration Joint Boards (IJBs), which are also local government bodies, following their first full year of operation in supporting health and social integration. A programme of audit work looking in more detail at health and social care integration and IJBs is under way.[1]

3. The report is in three parts:

- Part 1 (page 10) comments on councils' income and budgets for 2016/17.
- Part 2 (page 20) looks at councils' financial performance during, and position at the end of, 2016/17.
- Part 3 (page 33) looks at councils' 2017/18 finances and the challenges faced going forward.

4. Our primary sources of information are councils' 2016/17 audited accounts (including management commentaries) and their 2016/17 external annual audit reports. We have supplemented this with data submitted by councils to the Scottish Government through local finance returns (LFRs) and Provisional Outturn and Budget Estimates (POBE). LFRs present spending information for councils on a different basis from the spending information that councils record in their annual accounts. We do not audit data contained in LFRs.

5. UK-wide changes to the format of council financial statements in 2016/17 mean that we are no longer able to compare spending on services across councils using the annual accounts. This includes changes that make it difficult to establish the true service income and expenditure totals. We will include further analysis of these areas in our local government overview report in April 2018, using Scottish Government LFR data.

6. We refer to 'real-terms' changes in this report. This means we are showing financial information from past and future years at 2016/17 prices, adjusted for inflation, so that they are comparable to information from councils' 2016/17 accounts. We also refer to figures in 'cash terms'. This means we are showing the actual cash or money paid or received.

7. Throughout the report, we identify examples of questions that councillors may wish to consider to help them better understand their council's financial position and to scrutinise financial performance. The questions are also available on our website in ***Supplement 1: Scrutiny tool for councillors***.

8. Accompanying this report, and to facilitate insight and comparisons across the sector, we have provided additional financial information on our website. The information is based on councils' audited accounts. We hope this will be useful for senior council finance officers, their staff and other interested stakeholders. We have also produced a separate supplement on councils' Housing Revenue Account (HRA) and the Local Government Pension Scheme (LGPS).

9. Throughout this report Orkney and Shetland have been excluded from exhibits that show usable reserves and debt. This is because the levels they hold mean inclusion would make it difficult to see relative positions of other councils. Most councils hold usable reserves of between five and 35 per cent of their annual income, whereas Shetland's reserves were 250 per cent of its annual income and Orkney's 300 per cent of its annual income. These large reserves relate to oil, gas and harbour related activities. As a result, both Orkney and Shetland also have more investments than borrowing unlike other councils.

Part 1

Councils' income and budgets for 2016/17

Key messages

1 2016/17 was a challenging year for councils with a real-terms reduction in revenue funding, a continuation of the council tax freeze, inflationary pressures and the cost of new UK and Scottish Government policy commitments.

2 Councils depend on Scottish Government funding for the majority of their income. The largest element of Scottish Government funding, relating to Grant Aided Expenditure, has remained largely unchanged since 2008/09, with additional funding linked to supporting national policies. The Scottish Government and COSLA should assure themselves that the funding formula remains fit for purpose in a changing landscape for local government. It is important that it is suited to improving outcomes for local communities and sensitive to priorities such as reducing inequality within and across council areas.

3 In response to funding reductions, councils approved about £524 million of savings and the use of £79 million of their reserves when setting budgets for 2016/17. Councils' savings plans have focused on reducing staff numbers, rationalising surplus property and improving procurement of goods and services. Councils were not always clear in their budget-setting reports about the risks associated with savings and their potential impact on levels of service.

4 Councils' budget-setting processes for 2016/17 were complicated by later confirmation of funding from the Scottish Government and the funding arrangements for integrating health and social care.

5 Councils set larger capital budgets in 2016/17 than in 2015/16. The Scottish Government capital grant fell and councils planned to fund expenditure through increased borrowing.

2016/17 was a challenging year for councils

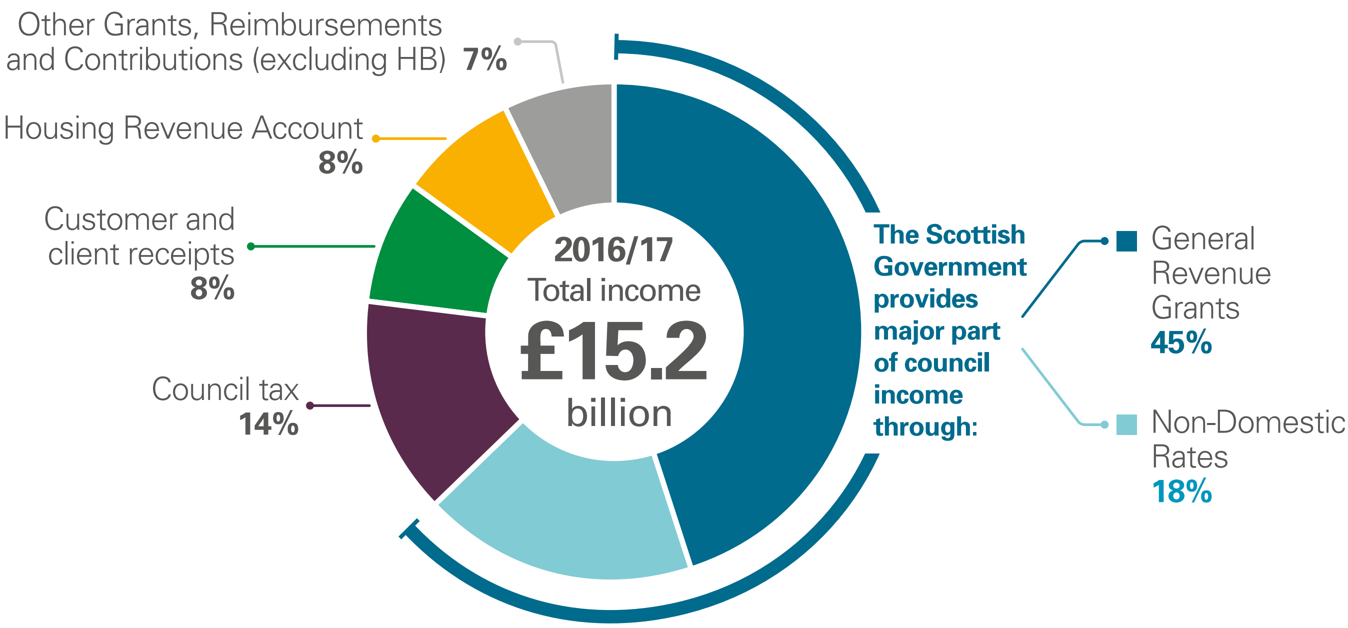
Councils faced a major challenge from the significant fall in revenue funding for 2016/17

10. The Scottish Government provides almost two-thirds of councils' income through general revenue grant, non-domestic rates (NDR) and specific grants for things like community justice (Exhibit 1, page 11). In comparison, council tax accounts for 14 per cent of councils' income, and fees and charges about eight per cent of their income.[2]

Exhibit 1

Sources of council revenue income, 2016/17

Councils are dependent on the Scottish Government for the majority of their income.



Notes:
1. Does not include all income collected for services delivered through council arm's-length external organisations (ALEOs) and Integration Joint Boards (IJBs).
2. Income excludes housing benefit.
3. Customer and client receipts are 2015/16 totals at 2016/17 prices.

Source: Annual accounts 2016/17 and Scottish Local Government Finance Statistics 2015-16

11. Scottish Government revenue funding for councils in 2016/17 fell by 5.2 per cent in real terms (Exhibit 2). Councils' revenue funding from the Scottish Government has fallen in real terms by 7.6 per cent since 2010/11. The size of the reduction in 2016/17 presented councils with a major challenge in delivering services and required most to identify significant savings.

Exhibit 2

Scottish Government revenue funding to councils

Revenue funding fell both in cash and real terms in 2016/17 compared to 2015/16.

	2016/17 £'000	Change on 2015/16	
		Cash %	Real %
NDR	2,769	-0.7 ▼	-2.7 ▼
Revenue Grant	6,939	-4.3 ▼	-6.2 ▼
Total revenue funding	**9,708**	**-3.3 ▼**	**-5.2 ▼**
Additional resource via IJBs	250		
	9,958	**-0.8 ▼**	**-2.8 ▼**

Source: Local Government Finance Circular 1/2017, Scottish Government

12. In 2016/17, the Scottish Government transferred an additional £250 million from the health budget to support health and social care integration. Even taking this into account, total revenue funding for councils fell in 2016/17.

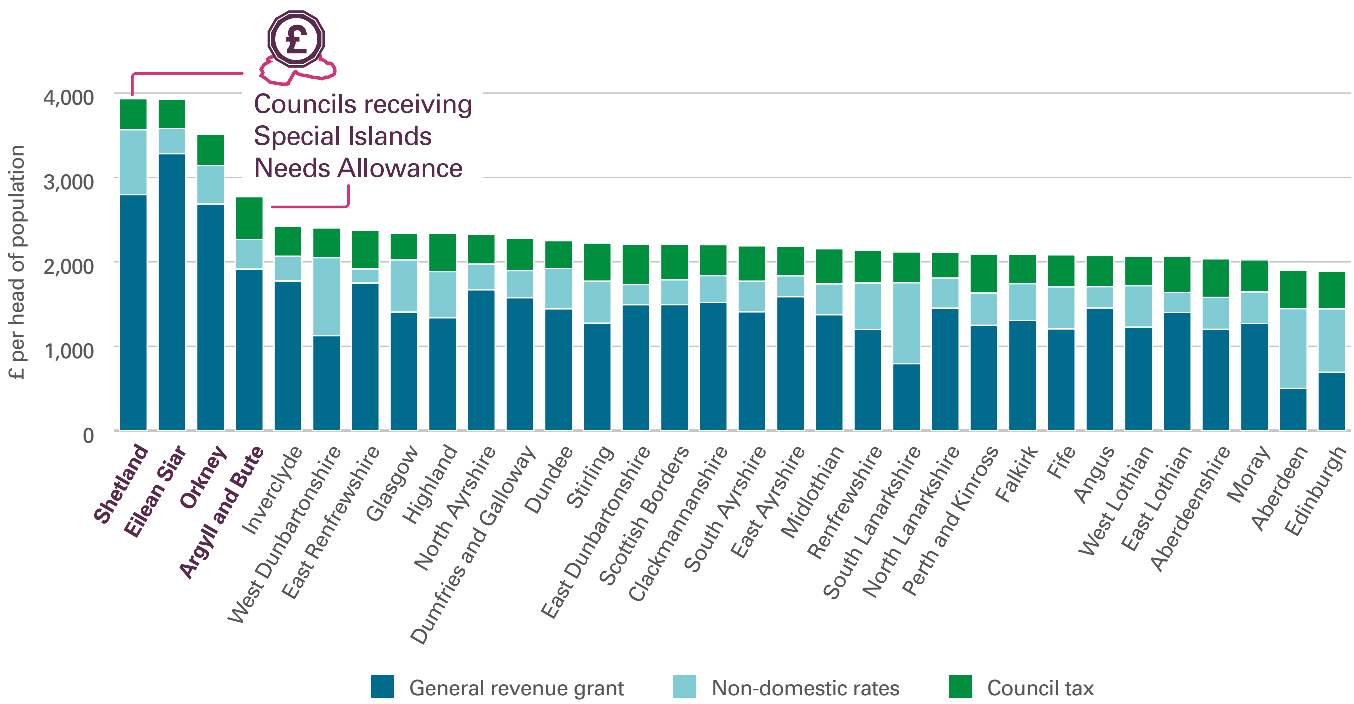
13. Council tax is a key source of income for local government. Councils have typically set council tax rates to reflect local policy choices. Between 2008/09 and 2016/17, councils agreed with the Scottish Government to freeze council tax rates. To compensate them, the Scottish Government provided local government with an additional £70 million in each year of the freeze. In 2008/09, £70 million represented just over three per cent of council tax income and councils each received a share in line with their tax base. Councils that may not have increased their council tax by this amount each year will have benefited from additional funding as a result of the freeze. Councils did, however, lose the option of raising council tax to generate additional revenue. Although the council tax freeze was lifted in 2017/18, councils were constrained to increases of three per cent.

14. The revenue funding that councils received from the Scottish Government and council tax income varied between £2,000 and £2,400 per head of population for most councils in 2016/17 (Exhibit 3). This impacts on the income they have available and on the decisions they need to make about delivering services. The income per head of population in Argyll and Bute, Eilean Siar, Orkney and Shetland is higher than in other councils because they receive extra funding for their island populations, in recognition of the additional costs they face when providing services.

Exhibit 3

Income from General Revenue Grant, Non-Domestic Rates and council tax per head of population, 2016/17

Most councils received between £2,000 and £2,400 per head of population.



Source: Annual accounts 2016/17; and National Records of Scotland mid-year population estimate for 2015

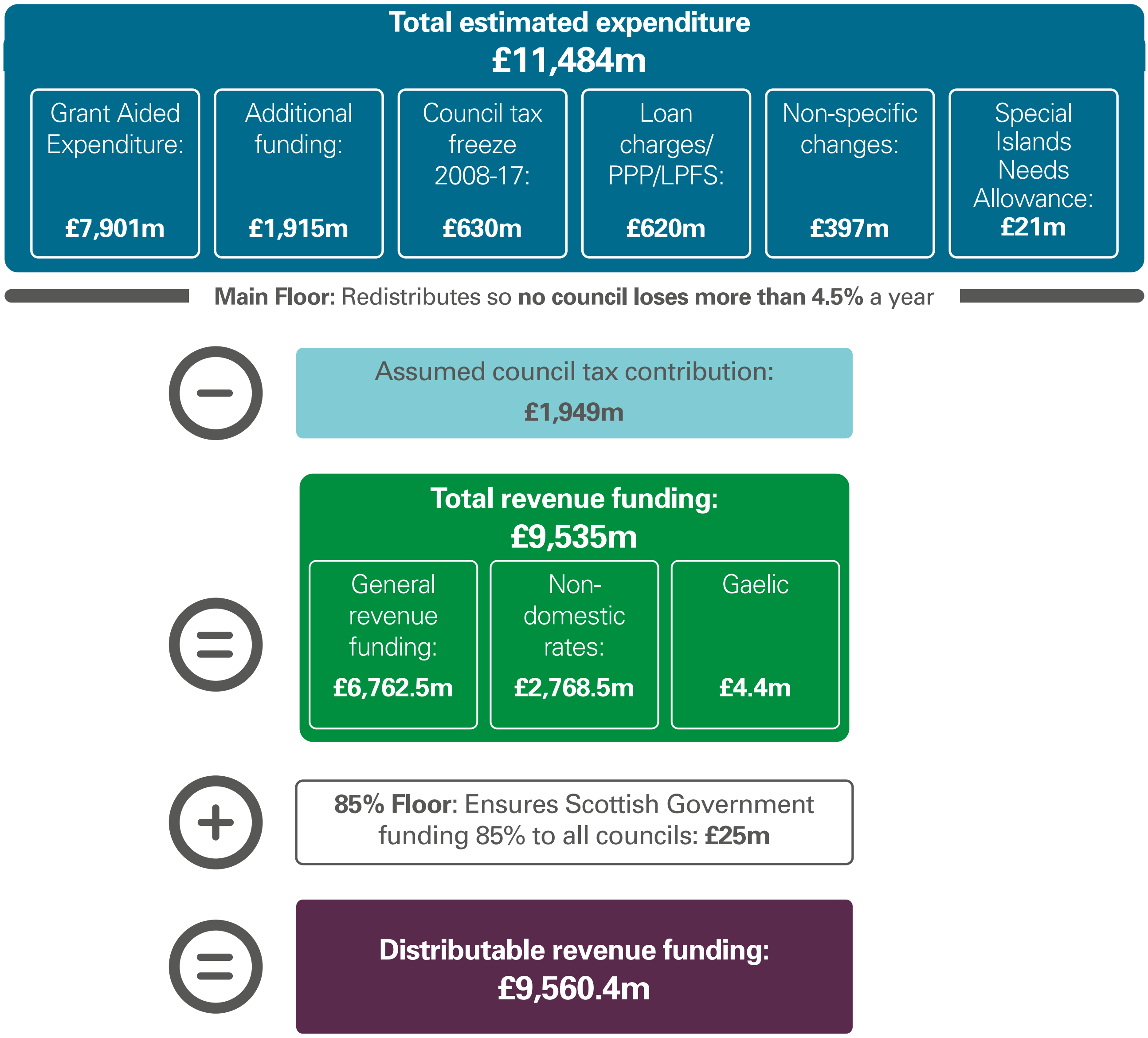
Additional Scottish Government funding has been linked to supporting national policies

15. The Scottish Government funding mechanism is the main determinant of a council's overall funding. It is designed to reflect differences between councils in terms of population and other factors, such as geography and deprivation. The funding mechanism is based on a large number of elements as illustrated in Exhibit 4 (page 14). The Fraser of Allander Institute has provided a useful outline summary of how funds are allocated:

> 'The Scottish Government allocates grants to local authorities taking into account both the relative spending need of each authority, and the revenues raised from council tax and non-domestic rates income.
>
> The grant allocation system first calculates the 'total estimated expenditure' (TEE) that each local authority is likely to need to meet its various commitments. The elements of TEE are:
>
> - an assessment of spending needs, based on the Grant Aided Expenditure (GAE) assessments combined with a Special Islands Needs Allowance (SINA)
> - a series of additional revenue grants – such as the funding used in the past to support the council tax freeze – the allocation of which is determined on a case-by-case basis
> - a series of further non-specific changes to grant allocations, the allocation of which is based on local authorities' shares of GAE + SINA
> - local authorities' commitments in respect of certain historic loan charges
> - the sum of these elements is then adjusted by a 'floor' to ensure that no local authority experiences particularly large swings in support from one year to the next.
>
> Having calculated TEE, an adjustment is then made based upon an estimate of what each local authority is expected to raise from council tax, the revenues that each local authority is forecast to raise from non-domestic rates, and their allocation of ring-fenced Gaelic funding. A further 'floor' calculation is applied to ensure that no local authority receives less than 85 per cent of the Scottish average on a per capita basis.'[3]

16. Within the Scottish Government's estimate of councils' TEE in any year, the largest element is Grant Aided Expenditure (GAE). GAE totals have remained broadly the same since 2008/09, with the exception of funding for police, fire and district courts having been removed. In 2016/17, GAE was £7.9 billion of a total estimated expenditure of £11.5 billion. GAE is distributed between councils based on an estimate of their relative spending needs across 89 elements, with reference to one or more indicators. For example, the GAE for primary education is allocated with reference to its share of primary school aged pupils. A small adjustment is made based on a secondary indicator of the percentage of pupils in small schools. The variations between councils in each of the elements are mostly determined by population profiles, although other factors to reflect rurality and deprivation are also used when appropriate.

Exhibit 4
Local Government funding mechanism, 2016/17
The formula contains many elements.



Notes: On top of distributable revenue funding, councils also received £133 million from other grants and payments such as the Teacher Induction Scheme and Discretionary Housing Payments.
In 2016/17, the 85 per cent floor was applied to funding for Aberdeen City and City of Edinburgh Councils.

Source: Audit Scotland and Fraser of Allander Institute

17. New funding for councils since 2008/09, for example funding to expand early years' childcare, has come as 'additional funding' and 'non-specific changes' and is funding specifically directed at delivering particular national policies. The proportion of council funding directed towards national policies is increasing, a trend that will continue with Scottish Government proposals for fairer funding for equity and excellence in education. This shift increasingly restricts the flexibility councils have in managing their budgets across their full range of services. The Scottish Government and COSLA should assure themselves that the funding formula remains fit for purpose in a changing landscape for local government. It is important that it is suited to improving outcomes for local communities and sensitive to priorities such as reducing inequality within and across council areas.

Councils faced increased budgetary pressures in 2016/17

18. Councils faced a growing range of budgetary pressures in 2016/17 from the real-terms reduction in Scottish Government funding, the continuation of the council tax freeze and cost inflation. They also faced additional pressures in meeting new UK and Scottish Government policy commitments. Many of the budgetary pressures that councils faced were associated with staff. As councils' largest area of expenditure, additional staff-related costs have a very significant impact on their budgets (Exhibit 5).

Exhibit 5

Significant budgetary pressures on councils in 2016/17

UK and Scottish Government policy commitments had sizeable cost implications for councils.

The **move to the single state pension at UK level.** This ended the employer NI rebate in relation to staff in contracted-out pension schemes (such as the LGPS and Teachers schemes).

3.4 per cent increase in NI costs affected employees from 1 April 2016.

The cost of introducing the **living wage for social care workers** from 1 October 2016.

Estimated cost of £100 million.

The undertaking to **maintain teacher numbers in Scotland** and the **Teacher Induction Scheme**.

Councils spend around £2.4 billion on teachers. By not cutting teacher numbers they receive a share of £88 million extra funding.

Annual increases in staff costs.

Estimated cost of one per cent pay rise about £70 million. Costs also increase as staff move up pay scales.

The **full year effect of increased pension contributions for teachers** (increased from 14.9 per cent to 17.2 per cent from September 2015).

The estimated impact was around £20 million in 2016/17.

Source: Audit Scotland

19. In addition to the costs of meeting government policies and inflationary pressures, councils also had to deal with ongoing demand pressures. Some demand pressures such as those associated with an ageing population and placements for looked-after children, are often not easy to forecast and budget for. This highlights the need for adequate budget contingency and robust arrangements for identifying and responding to changes in demand for services.

20. Rent arrears can also create budgetary pressures for councils' Housing Revenue Accounts. The Department for Work and Pensions (DWP) began a roll-out of Universal Credit (UC) in Scotland in March 2016. By March 2017, UC had rolled out across five councils.[4] Rent arrears across these councils increased in 2016/17 by an average of 14 per cent, compared with an average of 4 per cent across the remaining councils. Our *Housing Benefit Performance Audit: Annual update 2016/17* highlighted that councils are finding that the roll-out of UC is having a detrimental effect on their collection of housing rental income.

Some service areas saw larger reductions to budgets in 2016/17

21. In responding to the range of pressures they face, councils approved about £524 million of savings and budgeted to use about £79 million of reserves in their budgets for 2016/17. Savings plans continued to focus on their main areas of spend, reducing staff numbers, rationalising surplus property and improving procurement of goods and services. It was not always clear from budget-setting reports how savings aligned with the council's corporate and financial plans or how they would impact on service delivery.

22. In 2016/17, budgets for education increased, mainly as a result of the policy commitment to maintain teacher numbers and the inflationary pressures around pay and pension costs. Despite demand pressures in social work, overall budgets reduced – but not by as much in percentage terms as in other areas of service. Remaining service areas have seen larger reductions to their budgets. In some cases, increases in fees and charges may have reduced the amount of budgeted expenditure. This pattern of larger reductions to relatively smaller service areas has been recurrent in recent years and is something that has continued into 2017/18. While it is right that resources should be aligned with policy priorities, the impact on other services and their outcomes should be carefully assessed (Exhibit 6, page 17).

Councils have been seeking to maximise the income available to them from charging for services

23. Councils generate about eight per cent of their total income from charging for services (excluding housing rents). This includes income from charges to service users, rental income (excluding council houses) as well as 'other' charges. It is difficult to establish from the data available the full extent of income councils receive. Some income from services provided via arm's-length external organisations (ALEOs) and IJBs is not shown in council totals.[5]

24. Councils have been seeking to maximise their income through increasing charges and by introducing new charges for services, for example introducing charges for garden waste. Councils have also sought to collect more of the income that is due to them. Charges for social care which are subject to regulation, represented the largest area of income from charging services in 2015/16 (Exhibit 7, page 18).

Does your council have a charging policy? Is this in line with corporate plans and objectives? When was this last reviewed?

What information do you need to be able to explain increases in fees and charges to your constituents?

25. The Scottish Parliament's Information Centre (SPICe) has published a detailed briefing on some fees and charges. The Accounts Commission also considered fees and charges for services in its 2013 report, *Charging for services: are you getting it right?*

26. Although councils generate a relatively small proportion of their overall income from fees and charges, increases can make a difference to council finances over time. However, councils face difficult decisions in balancing their need to maximise income while also ensuring their charging policy is consistent with corporate objectives, such as providing access to services and addressing inequality. Increasing prices can be unpopular with the public, but effective leadership, sensitive management, good communications and community engagement can assist with this.

Exhibit 6

Trend in council expenditure on main services, in real terms

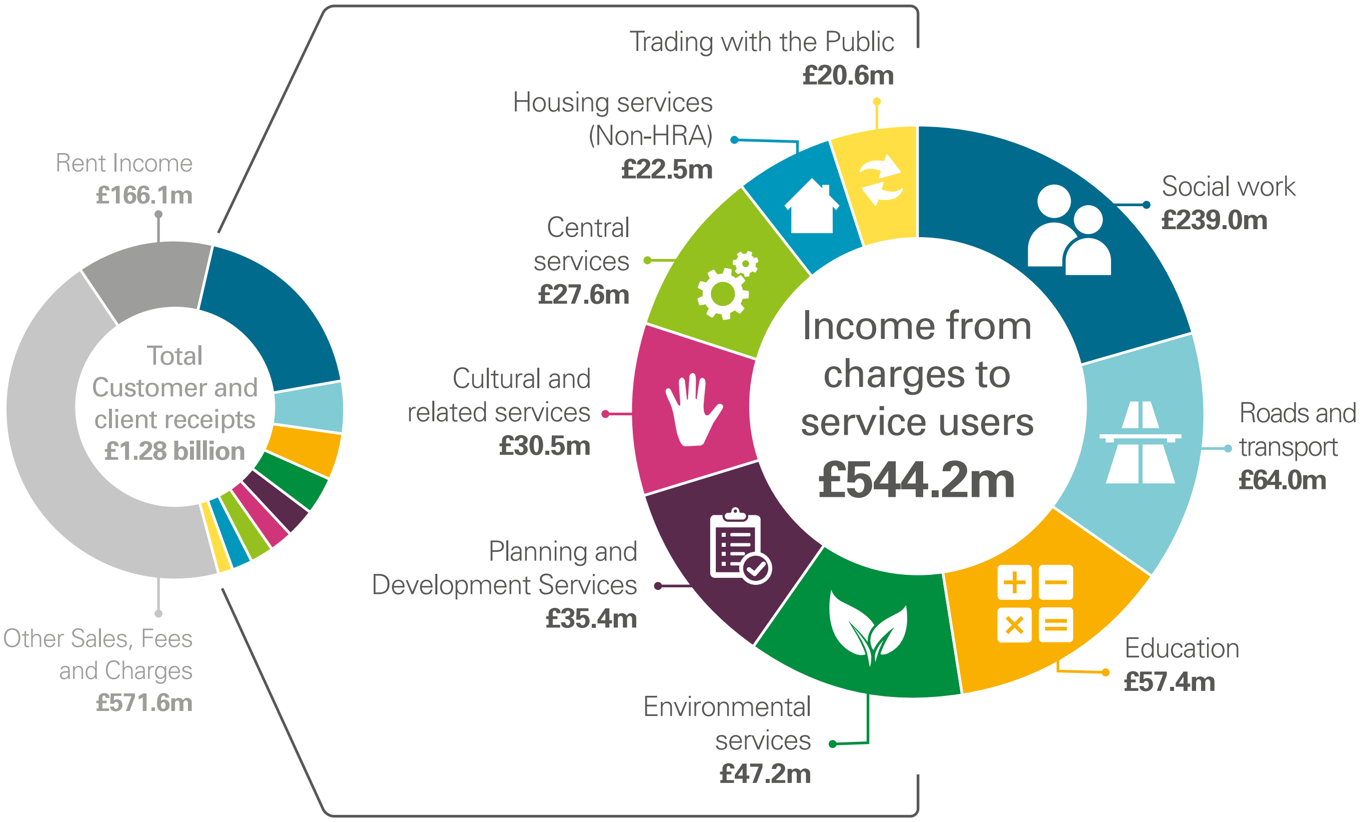
There was significant variation in budget changes across council services.

	2013/14 £million	2014/15 £million	2015/16 £million	16/17 Budget £million	Change over period
Education	4,771	4,736	4,830	4,826	1%
Cultural and related services	639	661	610	560	-12%
Social work	3,158	3,194	3,233	3,086	-2%
Roads and transport	454	431	427	419	-8%
Environmental services	686	684	698	668	-3%
Planning and development services	291	286	248	251	-14%
Other services	839	802	778	687	-18%
Total (excludes trading services and interest payments)	**10,840**	**10,793**	**10,823**	**10,496**	-3%

Note: 'Other services' combines Central Services and non-HRA housing.

Source: Scottish Local Government Finance Statistics 2015-16; and Scottish Government Provisional Outturn Budget Estimate returns 2016

Exhibit 7
Charges to service users
Charges to service users account for over £500 million of councils income.



Note: Does not include all income collected for services delivered through council ALEOs and IJBs.
Source: Scottish Local Government Finance Statistics 2015-16

Integration Joint Boards added further complexity to budget setting

27. For the majority of councils, 2016/17 was the first operational year for Integration Joint Boards (IJBs). IJBs were established as a result of the Public Bodies (Joint Working) (Scotland) Act 2014. They are partnerships between NHS boards and councils and are responsible for the delivery of adult health and social care, and in some council areas, for other services, such as children's services. The partnerships are the subject of 'integration schemes' which are written agreements about how they will operate, including responsibilities for any budget underspends and overspends.

28. Councils delegated £2.4 billion of social care expenditure to IJB budgets for 2016/17 and NHS boards contributed £5.6 billion. The introduction of IJBs has complicated budget-setting, due to differences in both the approach and timing of budget-setting between councils and NHS boards. The establishment and development of IJBs has been a complex exercise and will take time to mature. Their operation will be the focus of further performance audit work we have planned in 2018.

Councils set larger capital programmes for 2016/17, with plans to increase borrowing

29. In addition to their day-to-day revenue spending on goods and services, councils also incur capital expenditure on the assets that support those services, including schools, houses and equipment such as vehicles. In 2015/16, councils spent about £2.4 billion on capital projects. Budgets for 2016/17 were much higher at over £3.3 billion.

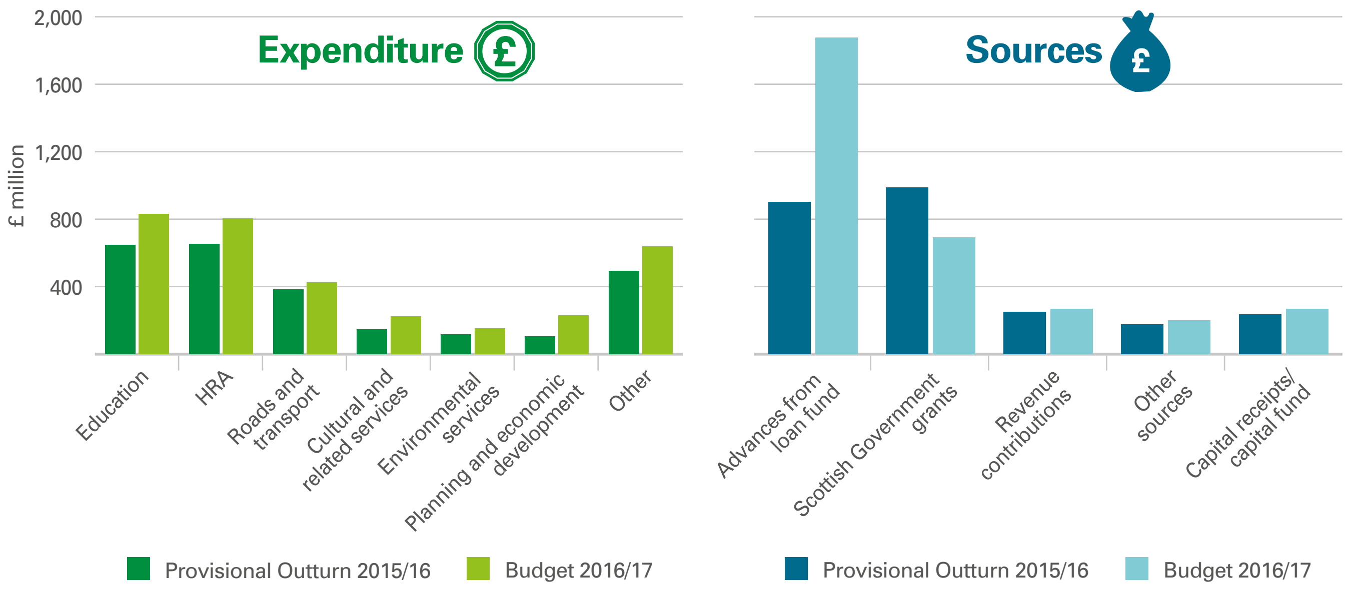
30. Councils finance their capital expenditure from a number of sources, including Scottish Government capital grants and borrowing. Scottish Government grants fell from £834 million in 2015/16 to £591 million in 2016/17, returning to a more usual level following re-profiling in earlier years. Exhibit 8 shows where councils were planning to spend their capital and how they planned to finance it.

31. Councils are required to consider the affordability of their capital programmes. This includes the cost of any borrowing along with the impact on day-to-day running costs. However, they are free to determine what they consider prudent and with interest rates remaining low in 2016/17, councils assessed increased borrowing to be affordable. The delivery of capital programmes and the affordability of debt are considered further in Part 2 and Part 3.

Exhibit 8

Capital programmes and sources of finance, 2015/16 and 2016/17

Councils planned to borrow more in 2016/17 to meet the cost of larger capital programmes.



Notes:
1. Excludes regional transport partnerships and Joint Valuation Boards.
2. Other budgeted use of capital includes Social Work, Central Services, Trading Services, etc.
3. Other sources of capital finance for the General Fund are grants (excluding those received from the Sottish Government).
4. For HRA this includes capital from other sources, such as developer contributions.

Source: Scottish Government Capital Provisional Outturn Budget Estimate 2015-16

Part 2

2016/17 financial performance

Key messages

1. All councils received an unqualified audit opinion on their 2016/17 accounts but the accounts could more clearly explain their financial performance.

2. Councils are showing signs of increasing financial stress with 20 councils drawing on their usable reserves in 2016/17.

3. Councils' actual use of reserves was often quite different from that originally planned. The reasons why are not always clear.

4. Auditors found that budget-setting needed to be more robust and that financial management could be improved in several councils.

5. Levels of net debt increased by £836 million in 2016/17. On average councils spent almost ten per cent of their revenue budgets servicing this debt. Some councils are concerned about the ongoing affordability of servicing their debt as resources decrease.

6. Councils that have been proactive in making difficult decisions will be better placed to deal with future financial pressures.

Twenty councils drew on reserves in 2016/17 – actual use of reserves was often quite different from original plans

All councils received an unqualified audit opinion on their 2016/17 accounts but the accounts could more clearly explain their financial performance to readers

32. In 2016/17, for the sixth consecutive year, auditors issued a 'true and fair' unqualified audit opinion on the accounts of all 32 councils. An unqualified opinion means auditors have judged that all council's financial records and statements are fairly and appropriately presented, that the council's financial statements are sound and free from material misstatements or errors.

33. For the last three years, councils have had to produce a management commentary to accompany their annual accounts. These commentaries play an important role in public accountability and helping interested parties to better understand the accounts of each council and its financial performance and position. As such, they should include explanations of amounts included in the accounts as well as:

- a description of the council's strategy and business model
- a review of the council's business
- a review of principal risks and uncertainties facing the council
- an outline of the main trends and factors likely to affect the future development, financial performance and financial position of the council.

34. Each management commentary should concisely present the financial 'story' of a council in an understandable format for a wide audience. Auditors express an opinion on whether the management commentary is consistent with the audited financial statements and is in line with Scottish Government guidance.

35. Management commentaries for 2016/17 vary in how clearly councils and IJBs explain their financial and general performance. Overall there remains scope for improvement. It is the Accounts Commission's view that councillors have an important role in ensuring that the management commentary effectively tells a clear story of financial performance and can be understood and scrutinised by a wide audience. The story at the end of the year should be produced from regular reports provided to councillors throughout the year.

?

Do management commentaries clearly explain council performance and any changes to plans?

Councils are showing increasing signs of financial stress

Twenty councils drew on their usable reserves in 2016/17

36. In 2016/17, 20 councils drew on their usable revenue and capital reserves. Nineteen councils drew on their revenue reserves in 2016/17, an increase from the eight councils that did so in 2015/16. Council revenue reserves fell by £32 million in 2016/17. (Exhibit 9, page 22). Overall council usable reserves (capital and revenue) fell by about £33 million.

37. The Chartered Institute of Public Finance and Accountancy (CIPFA) has identified the rapid decline of usable reserves as one of the symptoms exhibited by councils under financial stress.[6] Councils with good financial management demonstrate well-planned and managed use of reserves, in accordance with carefully thought out council policies.

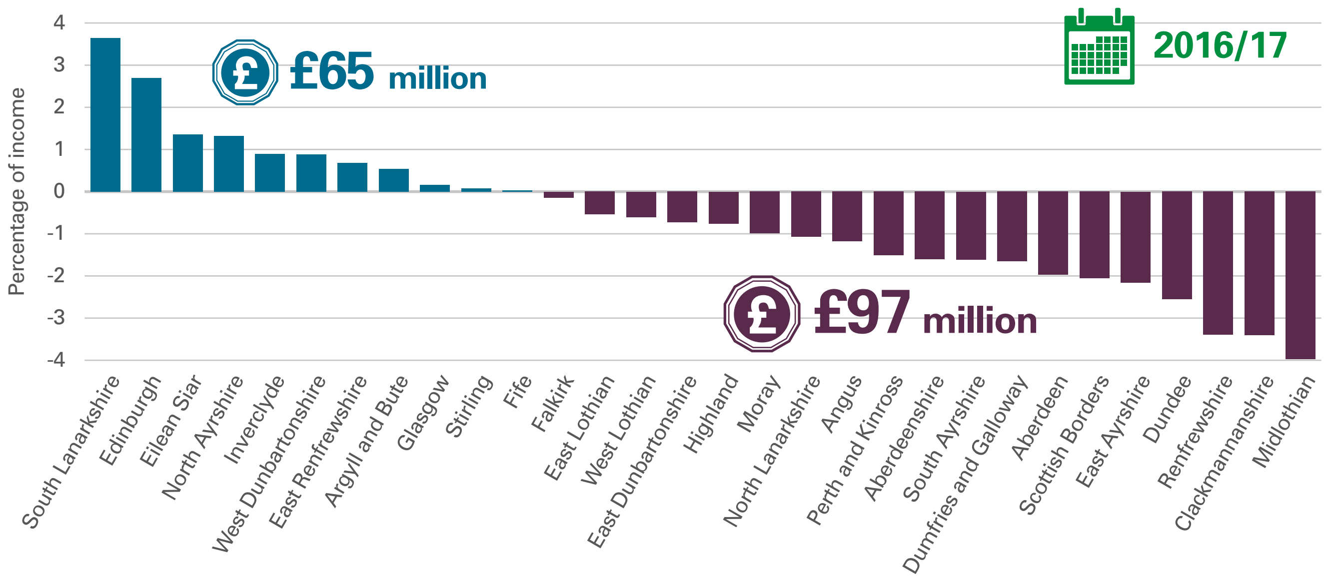
38. In some cases, councils have used reserves to support service delivery. Councils have used reserves to invest in their change programmes, such as meeting the additional costs of staff severance. In 2016/17, councils continued to focus on reducing staffing levels. They reduced their workforces by almost 2,200 staff (almost one per cent of the total workforce), at a cost of £78 million (Exhibit 10, page 23). Councils' policies around voluntary severance and redundancy typically require payback of the costs over two to three years.

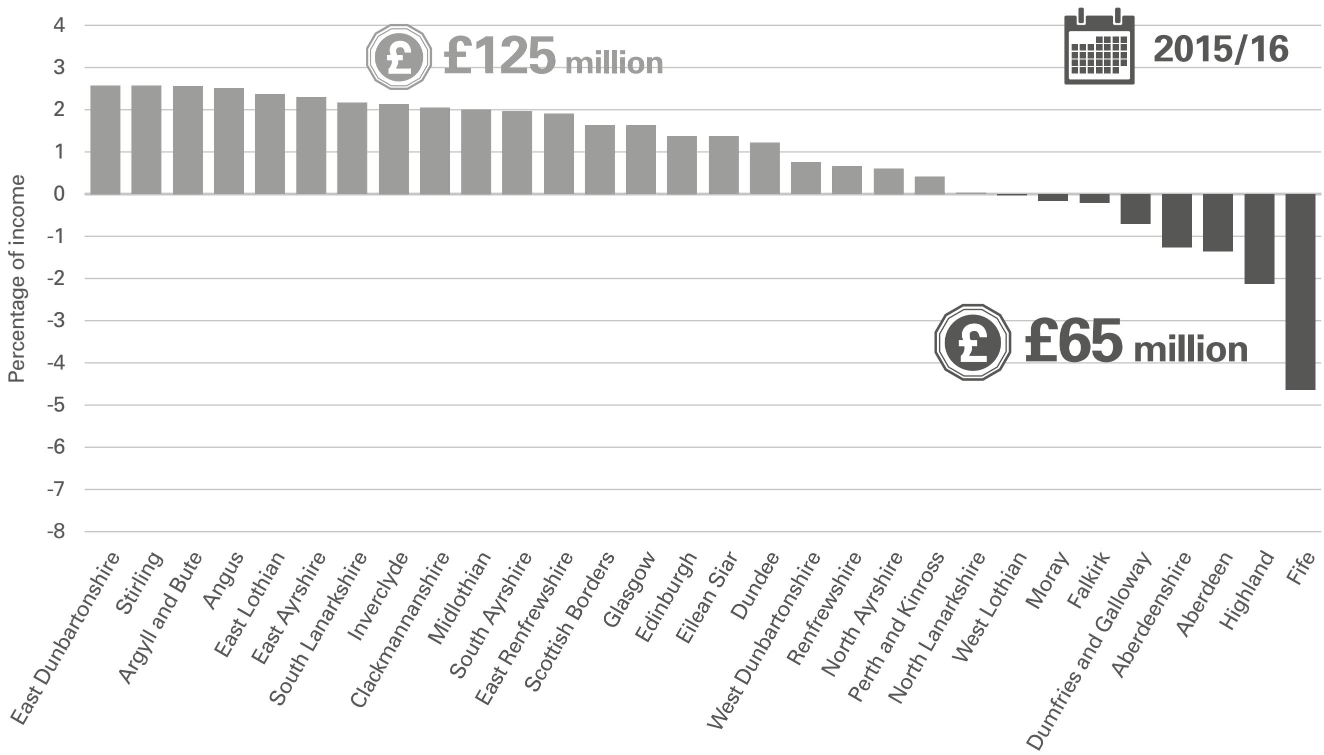
?

Are staff severances in line with the council's workforce plan?

39. In future, severance schemes could become less attractive for staff under Scottish Government proposals to limit payments. Conversely, severance packages for staff with retirement dates after April 2020 will become more expensive for councils following changes to pension protection.

Exhibit 9
Changes in revenue reserves (excluding HRA), 2015/16 and 2016/17
Many more councils drew on revenue reserves in 2016/17 compared with 2015/16.





Notes:
1. Due to issues with the scale on this exhibit Orkney and Shetland are excluded (paragraph 9).
2. In 2016/17, Renfrewshire moved money from revenue to capital reserves.

Source: Audited accounts 2015/16 and 2016/17

Exhibit 10
Exit packages, 2011/12 to 2016/17
The number and average cost of exit packages both fell in 2016/17.

	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	Total
Total number of packages	4,070	2,407	2,373	1,933	2,660	2,195	**15,642**
Total cost of packages Cash terms £000	148,750	109,068	92,640	74,935	97,231	78,125	**600,750**
Total cost of packages Real terms £000	160,868	115,528	96,535	76,955	99,172	78,125	**627,184**
Average cost per package Real terms £	39,525	47,997	40,681	39,811	37,227	35,592	**40,096**

Note: Real terms comparisons are based on 2016/17 prices.

Source: Annual accounts 2016/17

Councils use of reserves and service expenditure was often quite different from that originally planned

40. In 2016/17, as many councils used more reserves than they had originally planned as used less (Exhibit 11, page 24). It is not always clear from management commentaries why the actual use of reserves differed from that planned.

41. There can be a range of reasons why councils need to draw more heavily on their reserves than planned. It can be the result of poor budget-setting and/or budgetary control. For example, councils may need to use reserves to balance budgets where savings have not been achieved. The failure to deliver savings might be due to councils underestimating the time required for change programmes to deliver benefits. As budgets come under greater pressure from funding reductions, cost pressures and increasing demand, it is critical that councils understand the risks of using reserves in an unplanned way in relation to future savings and long-term financial sustainability.

42. Auditors identified that some councils failed to deliver their savings plans in 2016/17. Auditors also highlighted that some budgets did not properly reflect patterns of previous actual expenditure and that councils should consider rebasing their budgets where they consistently underspend. One such area is underspending on financing costs, where slippage on capital programmes leads to less borrowing and lower interest payments. Built-in budget contingencies partly explain budget underspends but councils need to explain this more clearly.

?

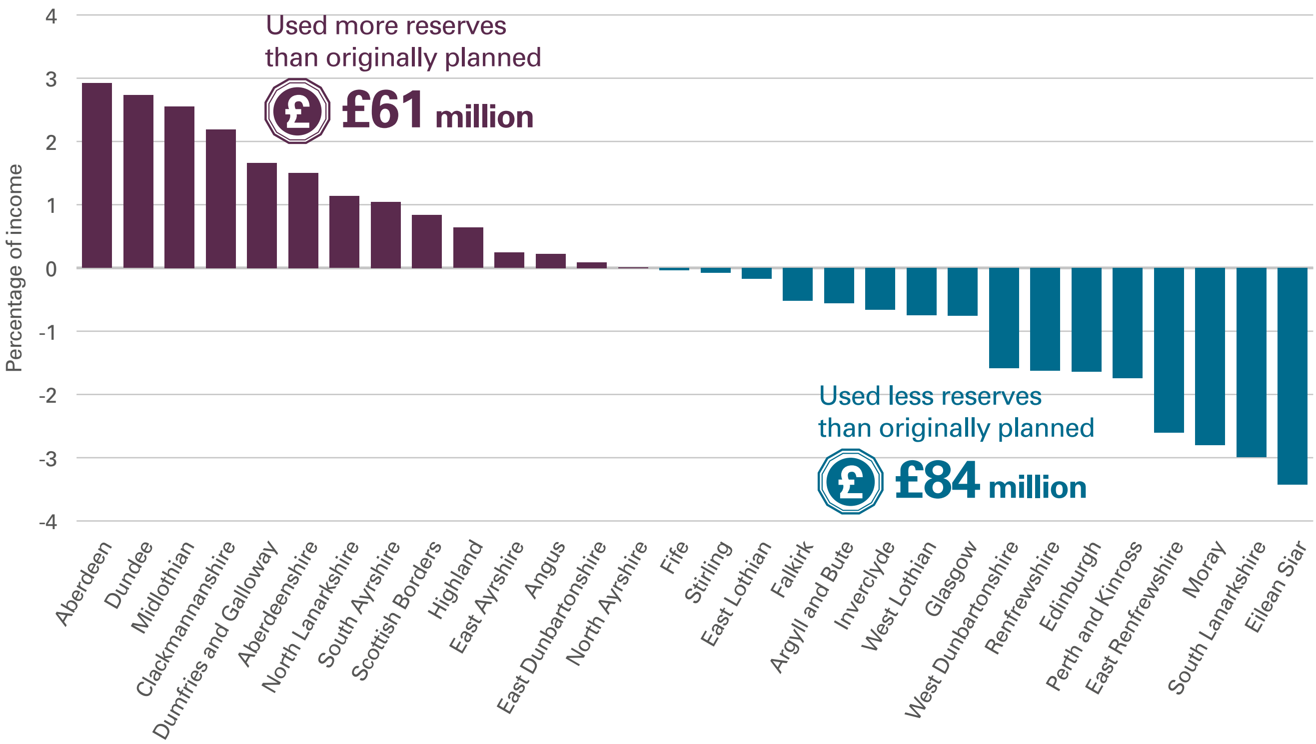
How does the council ensure that council staff have the capacity to delivery transformational change?

What have reserves been used for in recent years? Supporting services and bridging the funding gap or transforming services?

Exhibit 11

Difference between planned and actual use of General Fund reserves as a proportion of income, 2016/17

The difference between planned and actual use of reserves for some councils was more than two per cent of their total income from general revenue grants and taxation.



Note: Due to issues with the scale on this exhibit Orkney and Shetland are excluded (paragraph 9).

Source: Audited accounts 2016/17 and auditor returns

43. Reasons often cited by councils for under and overspends against final budgets are included in Exhibit 12 (page 25).

44. Management commentaries in councils' accounts tend to only identify the main reasons for over or underspends against final budgets and not why plans or budgets changed during the year. This represents an area of weakness in financial reporting that councils need to address to support more effective financial scrutiny. If significant changes are made to original budgets the reasons should be clearly reported to councillors throughout the year, as well as featuring in the management commentary accompanying the accounts at the end of the year.

Do budget monitoring reports clearly explain performance against plans and any changes to plans?

Exhibit 12
Commonly reported reasons for budget variances, 2016/17

Demand pressures primarily drove overspends – with financing costs a key driver of underspends.

Overspend

Health and social care
Increased demand for services

Early retirement
Severance schemes

Welfare reforms
Generated higher than expected demand

Education and children's services
- Out of school placements
- Residential placements
- Fostering and adoption

Underspend

Loan charges/ financing
Deferred borrowing and low interest rates

General costs
Lower than predicted inflation

Utility/Premises costs
Reduced insurance and utility costs

Staffing
Staff vacancies

Winter maintenance
Spend less than planned due to weather

Expenditure

Income

Planning and building control income less than planned

Trading operations not generating expected income

Council tax income greater than planned

Council tax reduction scheme income greater than planned

Source: Audit Scotland review of management commentaries

Levels of usable reserves vary widely and it is important that councils have clear reserves policies

45. The levels of usable reserves held by councils vary widely, as do policies on the minimum level of reserves they should hold. The General Fund reserve is the main revenue reserve available to support general council services. By the end of 2016/17, General Fund reserves, excluding Orkney and Shetland, totaled £1.1 billion. However, councils hold a number of other reserves and total usable reserves held amounted to £1.9 billion (excluding Orkney and Shetland, paragraph 9), (Exhibit 13, page 26).

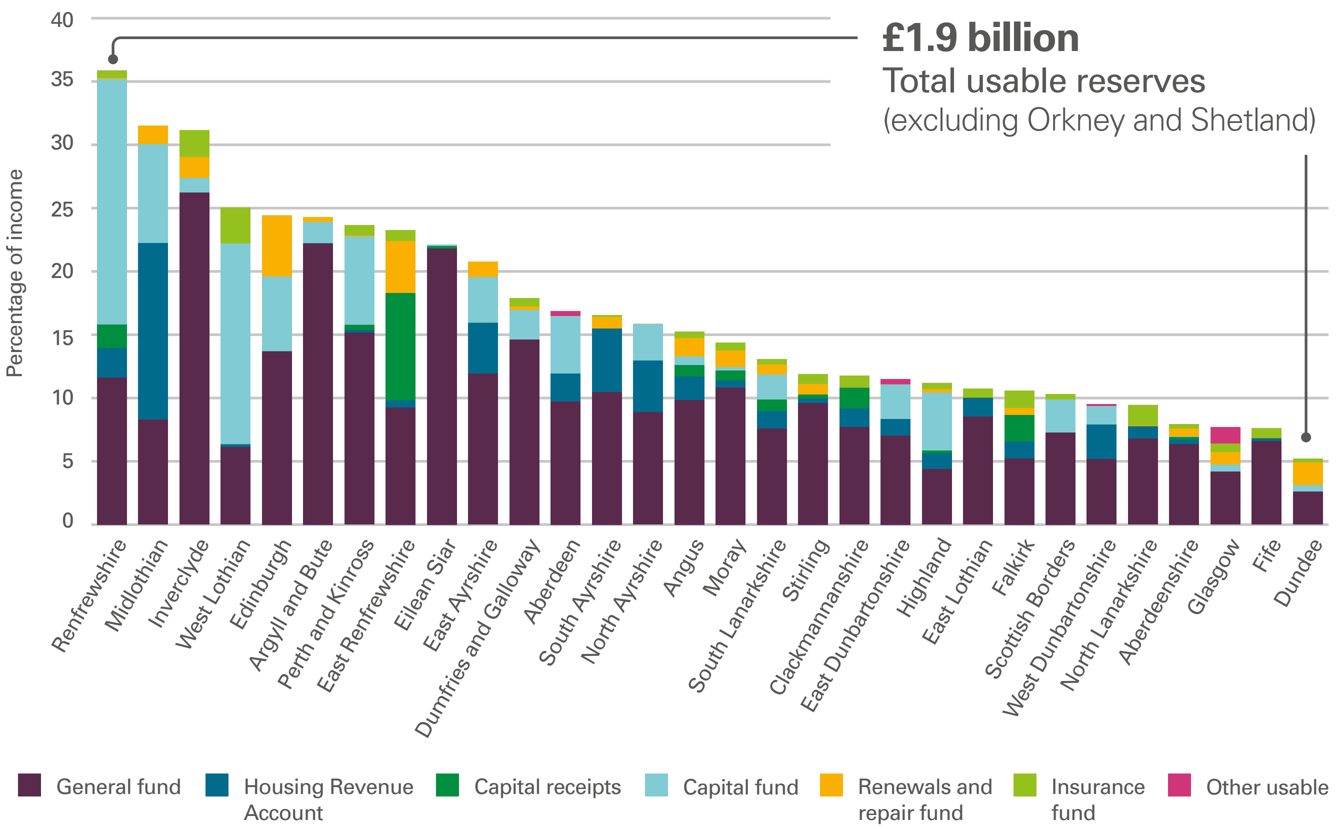
46. There is no prescribed minimal level of usable reserves. Typically councils' policies are to have a minimum uncommitted General Fund balance of between two and four per cent. Councils need to be clear about the reasons for the levels of reserves they hold to mitigate risks and support medium-term financial plans.

What is your councils reserves policy?

Exhibit 13

Council usable reserves at 31 March 2017

There are wide variations in the level of reserves as a proportion of income from general revenue grant, taxation and housing rents.



Note: Orkney and Shetland councils have reserves far in excess of those held by other councils and are excluded. We explain why this is the case in paragraph 9.

Source: Annual accounts 2016/17

47. At the end of their first full operational year, IJBs held usable reserves of £96 million, representing about 1.2 per cent of their total income of £8 billion in 2016/17. Reserves vary across IJBs. Not all integration schemes permit IJBs to hold reserves. Only North Ayrshire Council recorded an overspend. This was largely due to spending on social care services (Exhibit 14, page 27).

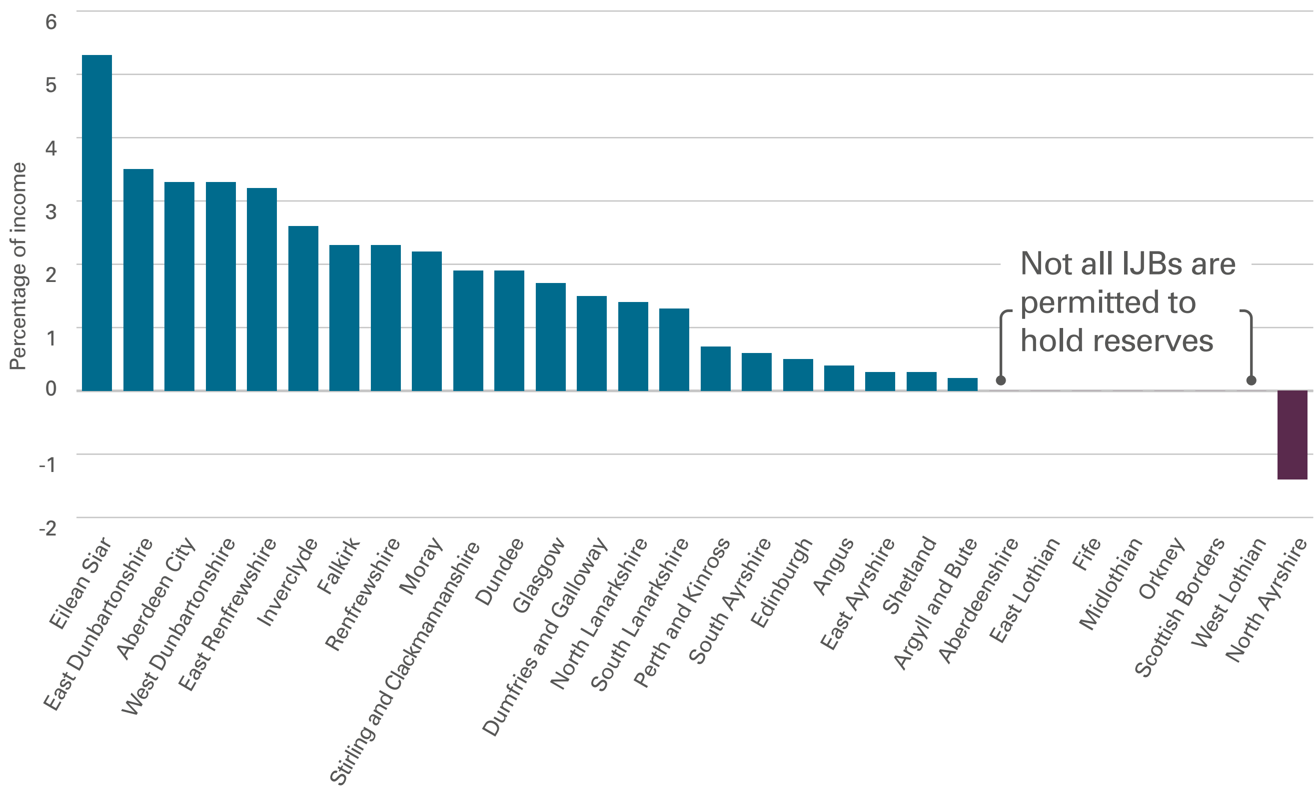
48. It is not clear from the accounts of IJBs to what extent reserves have been built up in a planned way, have arisen as a result of underspends on IJB activities or have been earmarked for transformation activity. There is a lot of pressure on the budgets of IJBs and reserves at the end of 2016/17 are not forecast to continue in future years. Further analysis of IJB accounts will help inform specific audit work on IJBs being carried out in 2018.

What are the different types of reserves your council holds? Do you know what these can be spent on?

Exhibit 14

IJB usable reserves as a proportion of 2016/17 income

Reserves vary across IJBs.



Note: Stirling Council and Clackmannanshire Council are members of the same IJB.

Source: Annual accounts 2016/17

Levels of debt have increased and some councils are concerned about future affordability

49. Following two years of reducing debt, councils' net debt increased in 2016/17 from £13.7 billion to £14.5 billion (excluding Orkney and Shetland). The increase in borrowing was lower than that originally planned when capital programmes were approved. This was primarily due to slippage in delivering capital programmes.

50. As with reserves, levels of debt vary widely across councils (Exhibit 15, page 28). 2016/17 saw an increase in the HRA borrowing requirement of about £140 million, with the 26 councils who provide social housing being actively involved in new council housing development. Collectively they plan to deliver about 13,000 homes by 2020/21. The cost of servicing additional HRA debt will be met from rental income.

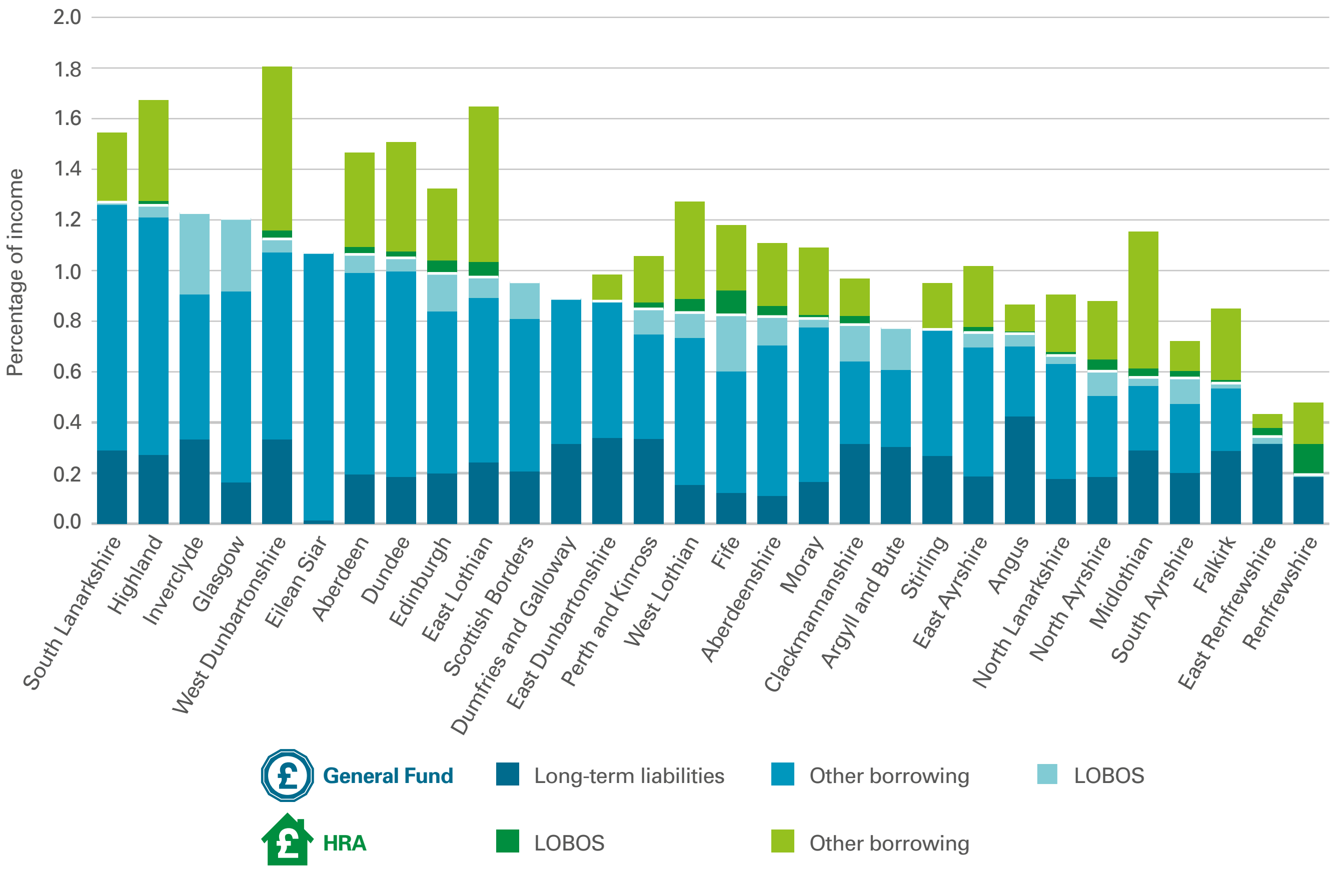
51. The ongoing costs associated with debt reduces the amount councils have available for day-to-day service expenditure. It is therefore important that assets are effectively supporting service delivery and strategic priorities. Higher levels of debt often result in higher costs for councils but actual interest and repayment costs will depend on the type of debt councils hold and the period over which it has to be repaid.

What are the levels of reserves held by your council's IJB? Are these in line with the IJB's reserve policy?

Exhibit 15

Council net external debt at 31 March 2017

Levels of debt held vary across councils as a proportion of income from general revenue grant, taxation and housing rents.



Note: Council debt has been allocated to General Fund and HRA in proportion to capital financing requirements.

Source: Annual accounts 2016/17

52. Despite debt increasing, the ongoing cost of servicing it, through the interest and repayment costs, reduced slightly in 2016/17. This in part reflects the lower interest rates available on new borrowing. It also reflects councils choosing to make lower voluntary debt repayments. On average, councils spent almost ten per cent of their income on interest and debt repayment (Exhibit 16, page 29).

53. Councils are required by regulation to consider the revenue impact of borrowing, ie its ongoing affordability. A large part of council debt has fixed interest rates which gives councils certainty about costs. However, this type of debt makes councils' assessment of longer term affordability more complex, requiring more detailed assumptions of future inflation and interest rates:

What share of your council's budget is taken up with interest payments and debt repayment?

- 'Lender option borrower option' loans (LOBOs) include options for the lender to increase interest rates. LOBOs account for about 11 per cent of council debt.

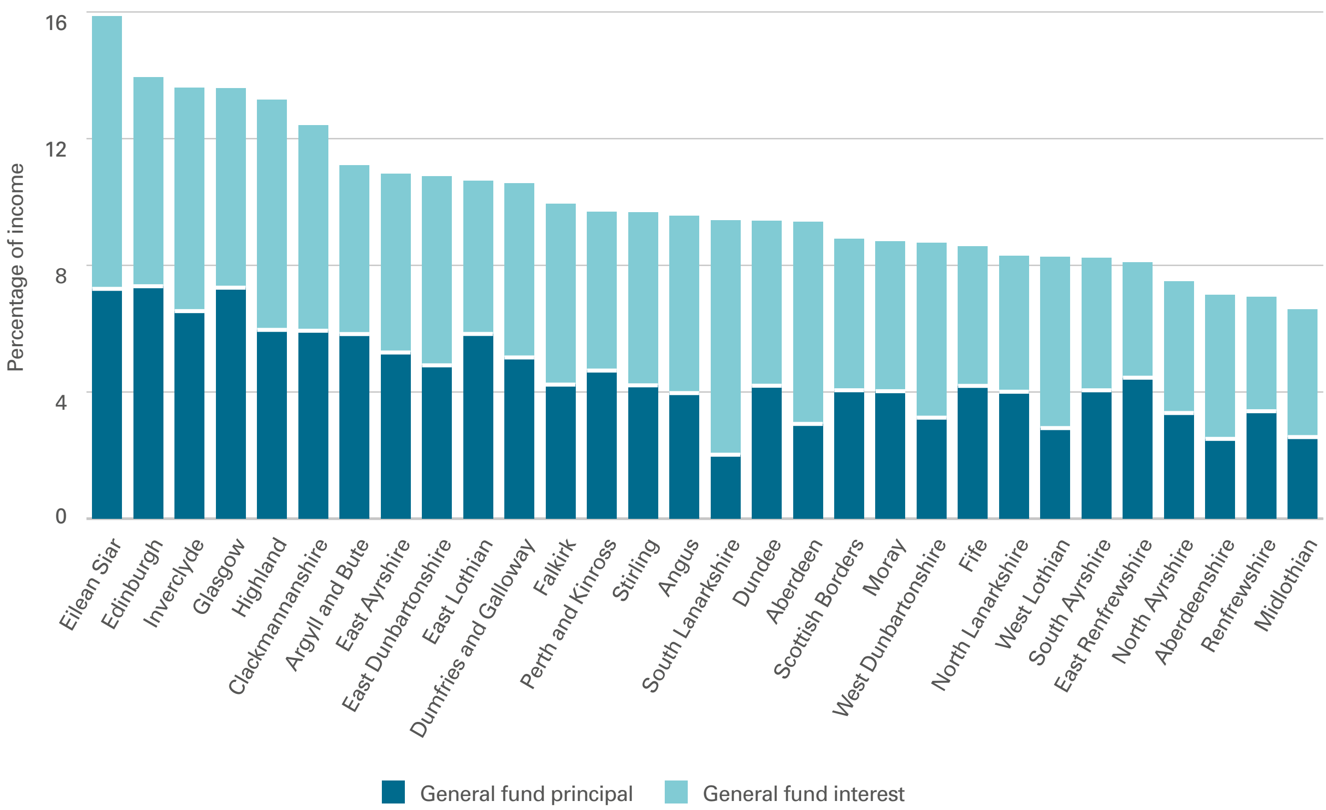
- PPP/PFI and indexed linked bonds include charges that increase with inflation. Projects financed using the Scottish Government's Non-Profit Distributing (NPD) programme (which replaced the previous long standing PPP/PFI programmes) also include an element of indexation but typically at lower levels. The value for money of newer NPD projects will be examined in detail in a joint report by the Auditor General and the Accounts Commission in 2019/20.

What proportion of your council's debt is linked to inflation (ie, subject to indexation)? What does that mean for longer term affordability?

Exhibit 16

Revenue cost of General Fund borrowing, 2016/17

Costs associated with debt vary across councils as a proportion of income from general revenue grants and taxation.



Source: Annual accounts 2016/17

54. Levels of debt and associated costs are set to rise in future. This is because councils have invested usable reserves in their capital programmes, something referred to as 'internal borrowing'. At the end of 2016/17 the amount of 'internal borrowing' was about £0.5 billion. Internal borrowing is usual treasury management practice for councils during periods when they would make a lower return from investing their usable reserves than it would cost them to borrow money. However, as councils increasingly rely on reserves to fund services they will need to replace internal borrowing with external borrowing, increasing their costs.

Councils continue to report significant slippage in delivering capital programmes

55. Councils spent £2.8 billion on capital projects in 2016/17, 84 per cent of their planned expenditure of £3.3 billion. Twenty-four out of 32 councils underspent against their capital budgets in both 2015/16 and 2016/17.

56. The reasons for slippage in delivering capital programmes are unclear. Management commentaries for the councils recording the largest slippage give reasons such as changes to project start dates, and one council identified weaknesses in the forward planning process. However, the consistent levels of capital slippage across the country suggest that councils are setting unrealistic budgets.

57. In our 2013 report *Major capital investments in councils* we noted 'that for most major projects completed within the previous three years, councils' early estimates of the expected costs and timetable were inaccurate, and recommended that better information was made publicly available'.[7] Our follow-up report in 2016 suggested councils had made limited progress on this recommendation.[8] Data for 2016/17 shows that councils still need to improve in this area.

Has non delivery of the capital programme (ie, slippage) been significant at your council in recent years? Why?

Net pension liabilities increased for councils despite large increases in pension fund assets

58. Overall, net pension liabilities on council balance sheets were approximately £11.5 billion at the end of 2016/17, an increase of 51 per cent on the previous year. This increase was mainly due to a change in actuarial assumptions used to value future liabilities. It was a good year for Local Government Pension Scheme (LGPS) investments, which increased by almost 22 per cent.

59. Not all council pension liabilities are the responsibility of the LGPS fund. Where councils have awarded added-year pension benefits as part of severance arrangements, for both teachers and other staff, they have to meet the ongoing cost of pensions themselves. This also helps explain why the increase in council liabilities outstripped investment returns. These liabilities are not matched with any pension fund assets.

Do you know the implications of your council's pension liabilities of staff retiring early?

60. Public service pension scheme benefits have been reduced on a number of occasions to make the schemes more affordable. However, pension contributions have been a significant cost pressure for councils in recent years. The need for any increase in employer contributions will be determined through the results of the 2017 triennial funding valuation. The LGPS 2015 includes a cost-sharing mechanism that will limit any future increase for employers. A supplement on the Local Government Pension Scheme is available on our website.

Provisions and contingent liabilities can be difficult to quantify and should be kept under review

61. Where councils have a known obligation and they can quantify the cost, they are required to make a provision in their accounts. Councils held provisions of £132 million at the end of 2016/17 covering areas such as equal pay compensation claims, teachers' maternity pay, holiday pay, insurance claims and landfill site reinstatement.[9]

62. Councils are also required to disclose potential liabilities that are still contingent on future events or which cannot be quantified reliably. Fourteen councils are disclosing contingent liabilities for equal pay claims that they are defending. Other contingent liabilities identified by a number of councils include those relating to holiday pay claims and potential claims arising as a result of changes to the legislation around historic child abuse.

Councils that have been proactive in making difficult decisions will be better placed to deal with future financial pressures

63. Councils have had to make difficult decisions in recent years in the light of falling resources and increasing demand for services. Councils that have a track record of effective leadership, self-evaluation, robustly addressing the financial challenges, and are implementing effective medium to long-term strategies and plans, will be in a better place than those that have avoided difficult decisions or not applied sufficient pace to making changes. That is not to say that the challenges faced by councils have necessarily been uniform. Differences in the resources available to them, the demand for services and the costs councils face as a result of their size and remoteness can also impact on their financial position (Exhibit 17, page 32).

64. The effectiveness of council leadership will be tested further in the years ahead given the increasing demand for services and likely funding scenarios that the public sector faces. Decisions made as part of budget-setting for 2017/18 together with the financial outlook are considered in Part 1 (page 10).

Exhibit 17
Main determinants of a council's financial position
There are number of factors that affect a councils financial position.

Source: Audit Scotland

Part 3

Financial outlook

Key messages

1 The financial outlook for councils remains challenging with further real-terms reductions in funding and a range of cost and demand pressures on budgets.

2 In total councils approved £317 million of savings and the use of £105 million of reserves when setting budgets for 2017/18.

3 Some councils relying heavily on the use of reserves to fund services will need to take remedial action or they will run out of General Fund reserves within two to three years.

4 Robust medium-term financial strategies and savings plans are increasingly critical to the financial sustainability of councils.

5 Strong leadership is increasingly important and it is essential that councillors work effectively with officers, their partners and other stakeholders to identify and deliver necessary savings. It is important that councils engage with local communities when planning and delivering services and identifying savings.

the financial outlook for councils remains challenging

Council funding continues to fall as cost pressures increase

Scottish Government funding fell again in real terms for 2017/18

65. Councils received a further real-terms reduction of 2.3 per cent in their funding from the Scottish Government for 2017/18, reflecting the overall trend and direction of travel (Exhibit 18, page 34).

66. Councils' funding continues to include money targeted at delivering national policy commitments that restricts the overall flexibility in their budget setting. In 2017/18, this included £120 million provided for the school attainment fund and £88 million for maintaining pupil teacher ratios and for the teachers' induction scheme.

How is your council preparing for any further real terms reduction in Scottish Government funding?

Exhibit 18
Scottish Government revenue funding to councils
Local government funding fell in real terms in 2017/18 compared to 2016/17.

	2017-18 £000	Change on 2016-17 %
Cash terms		
NDR	2,666	-3.7 ▼
Revenue Grant	6,974	0.5
Total revenue funding	**9,639**	**-0.7 ▼**
Additional resource via IJBs	357	
	9,996	**0.4 ▼**
Real terms – 2016/17 prices		
NDR	2,623	-5.3 ▼
Revenue Grant	6,862	-1.1 ▼
Total revenue funding	**9,485**	**-2.3 ▼**
Additional resource via IJBs	351	
	9,836	**-1.2 ▼**

Source: Scottish Government Finance Circular 1/2017

Reductions in Scottish Government funding were only partly offset by the end of the council tax freeze

67. The council tax freeze ended in 2017/18. Twenty-four councils chose to increase council tax, with 21 approving the maximum three per cent permitted. Fourteen councils chose to remove the ten per cent discount on second homes, another option for increasing revenue. For some councils, additional income from second homes is not significant.

68. Exhibit 19 (page 35) shows the additional income councils are due from council tax in 2017/18. Additional income arising from council tax reforms to banding multipliers are also shown, but councils do not benefit from these increases as the Scottish Government funding mechanism has been adjusted accordingly.

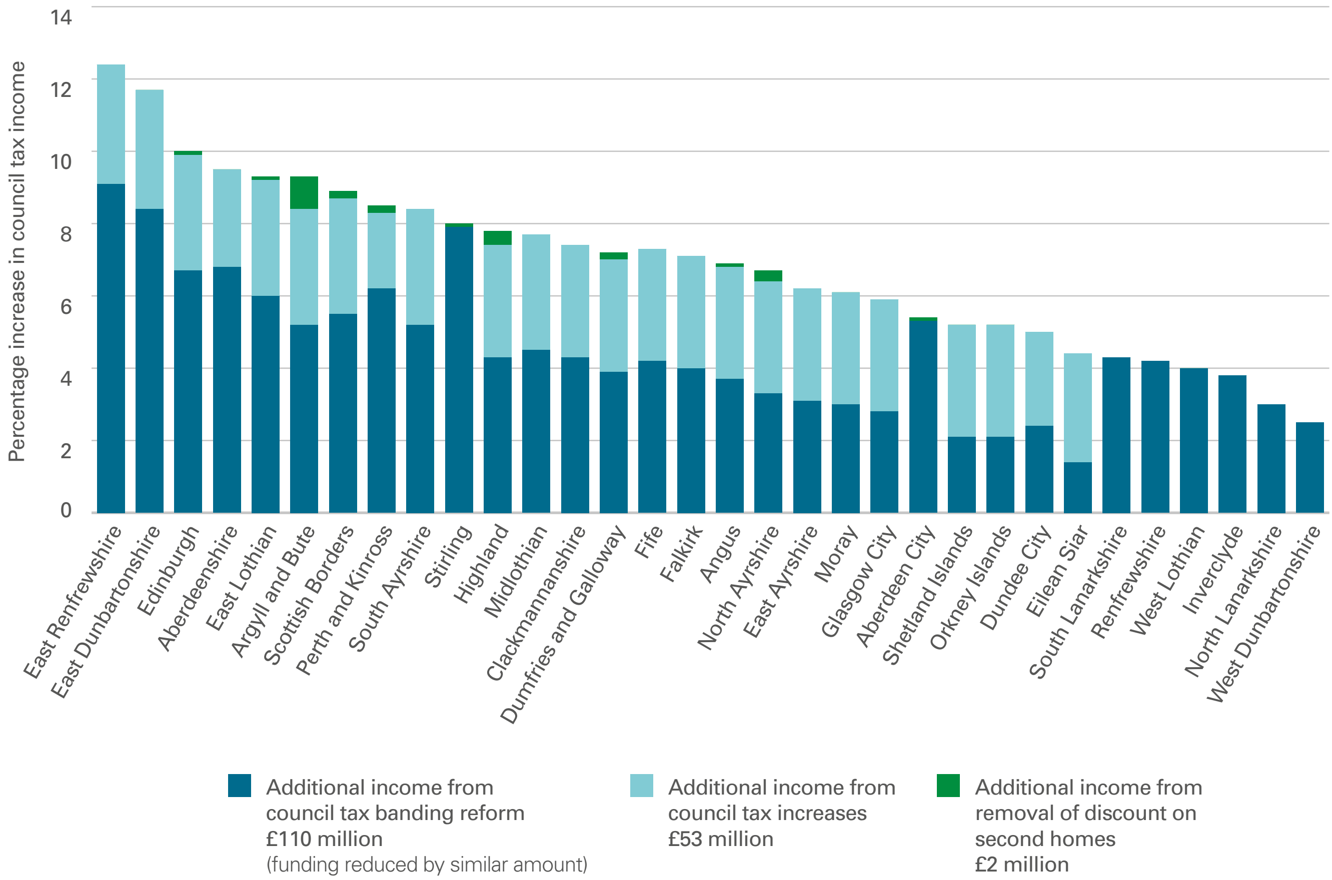
?

If your council plans to raise council tax, do you know how much it will raise? How will you communicate and explain the rise to constituents?

Exhibit 19

Increase in council tax by council, 2017/18

Council tax in 2017/18 has risen as a result of reforms and the end of the council tax freeze.



Note: Council tax due before any discounts are applied.

Source: Council tax banding information and SPICe

Delivering savings is critical for councils' financial sustainability

Councils approved savings of £317 million and the use of £105 million of reserves when setting budgets for 2017/18

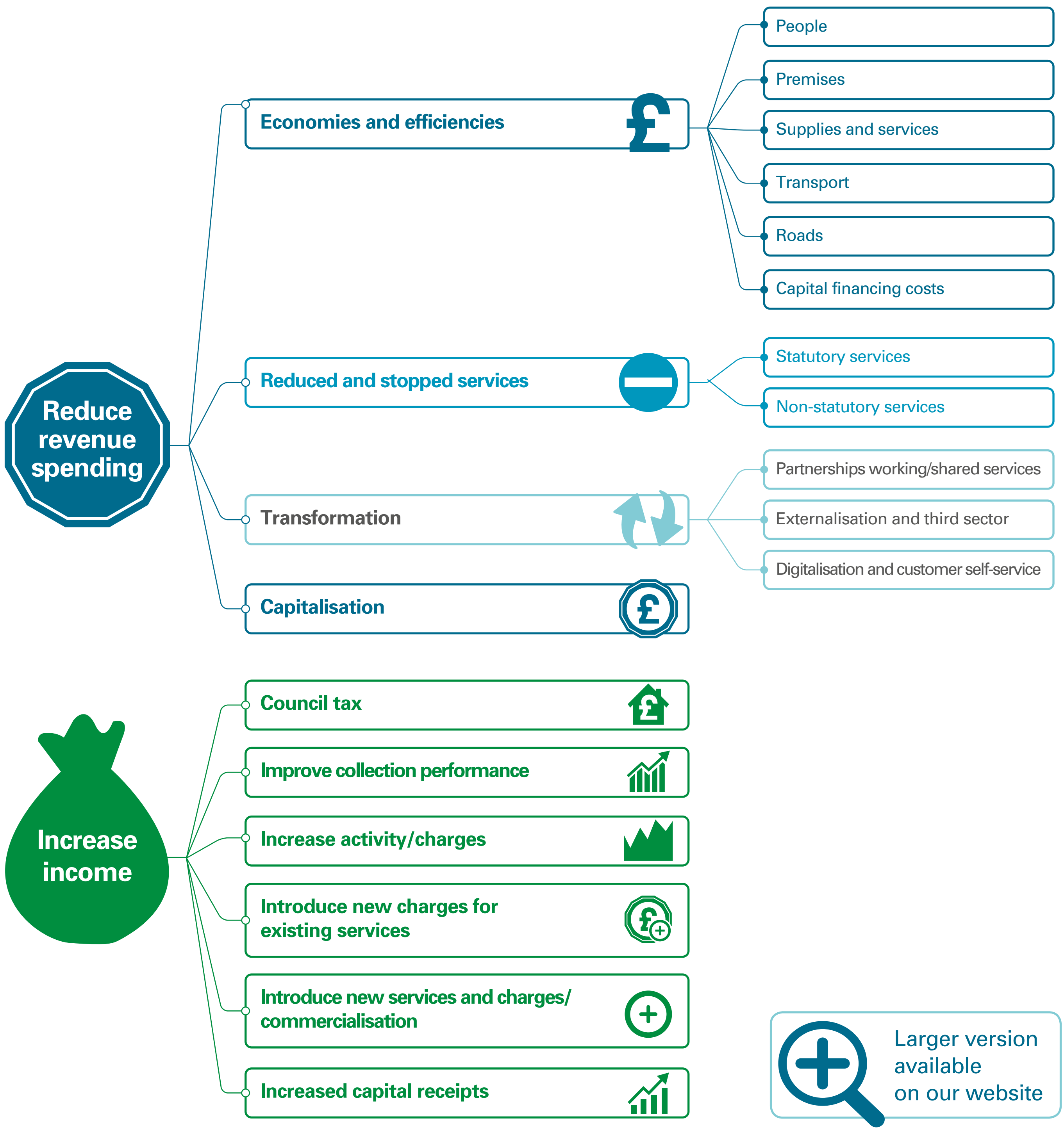
69. When setting budgets for 2017/18, councils had to take into account a number of new cost pressures, including:

- the introduction of the apprenticeship levy of 0.5 per cent of pay bills above £3 million
- the requirement to meet the first full year effect of the living wage
- meeting HMRC guidelines on paying the national minimum wage for care workers when sleeping over
- non-domestic rates (NDR) revaluation.

70. In balancing funding reductions and cost pressures, councils' 2017/18 budgets included approved savings of £317 million and the use of £105 million of General Fund reserves. Common measures taken by councils to close their funding gaps in 2017/18 are set out in Exhibit 20. Not all initiatives to reduce expenditure are savings, some simply deferred expenditure by moving it from revenue to capital.

Does your council have a savings plan? What are the options to close future funding gaps?

Exhibit 20
Measures taken by councils to close their funding gaps in 2017/18



Larger version available on our website

Source: Audit Scotland, analysis of budget setting reports 2017/18

What is the likely use of reserves for 2017/18? How does this compare to forecast funding gaps?

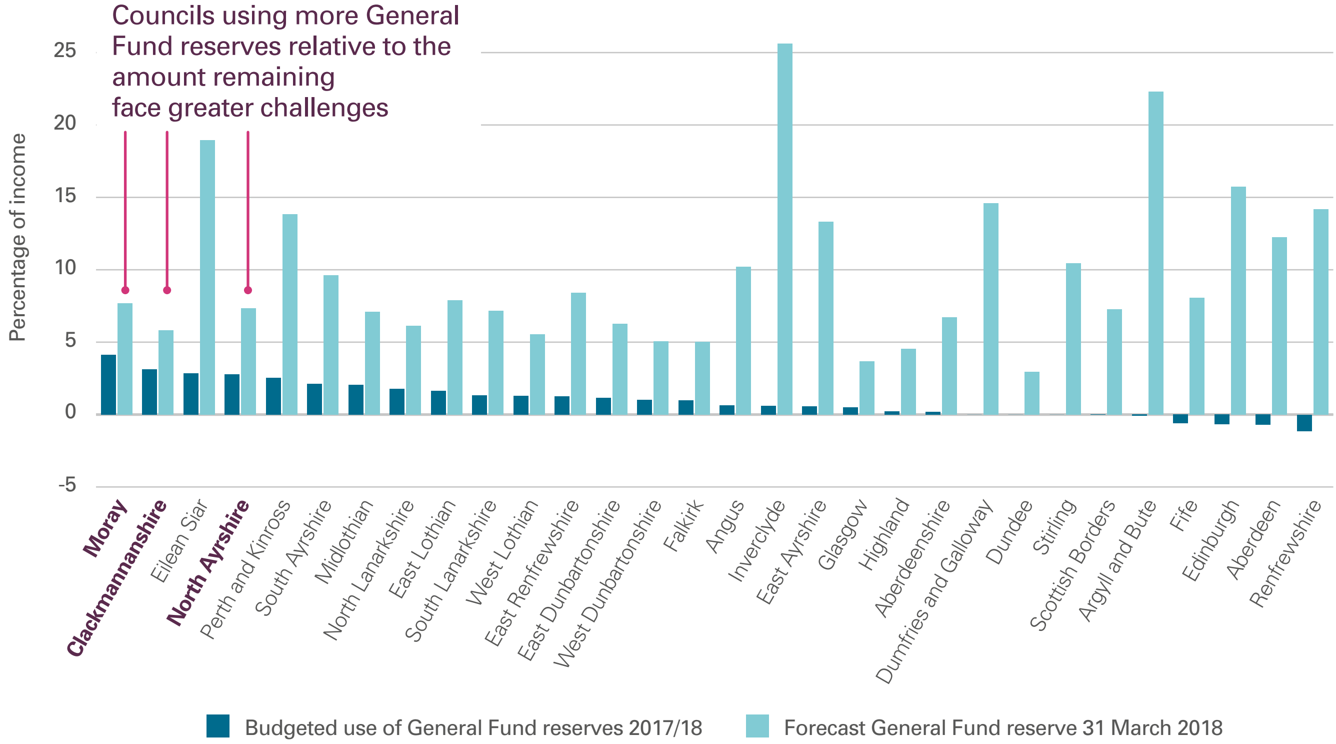
Some councils will need to take remedial action or they will run out of General Fund reserves within two to three years

71. Some councils' plans for 2017/18 have relied more heavily than others on using reserves to bridge funding gaps. A number of these councils could have relatively low levels of General Fund reserves remaining at the end of the year (Exhibit 21).

Exhibit 21

Budgeted use and remaining levels of General Fund reserves, 2017/18

Two-thirds of councils budgeted to use reserves in 2017/18.



Source: Annual accounts and auditor funding gap returns 2017

72. Councils using reserves to support services in 2017/18 will be faced with having to identify larger savings in 2018/19 or again using reserves. However, using General Fund reserves at the current rate is not an option for some councils – Clackmannanshire, Moray and North Ayrshire councils would run out of General Fund reserves within two to three years if they continued to use them at the level planned for 2017/18.

What is your council's financial position? What particular challenges does it face?

73. Forecasts made by councils when setting their budgets for 2017/18 indicated the overall local government funding gap would increase to about £350 million in 2018/19 and to about £650 million in 2019/20.[10]

74. Since setting 2017/18 budgets, councils will have changed their plans for the current year and updated their forecast funding gaps for 2018/19 and beyond. A number of factors have created further potential pressures and uncertainties, for example:

- ongoing demand pressures from people living longer and population growth
- ongoing cost pressures from general inflation

- increased staffing costs from staff moving up pay scales, proposals to end the public sector pay cap and potential increases in employers' pension contributions following the LGPS triennial funding valuation
- income and rent collection potentially becoming more difficult and costly as a result of increased charges and the continued roll-out of Universal Credit
- interest rate rises
- the potential impact from changes to NDR (as outlined in Exhibit 22)
- potential impacts from the process of withdrawal from the European Union.

Exhibit 22

Barclay review of non-domestic rates (NDR) 2017

The Barclay review recommended removing NDR relief for councils' ALEOs.

Councils collect NDR and pay this into a central pool, which is redistributed back to councils by the Scottish Government.

The Government established the Barclay review group in 2016 to make recommendations that would 'enhance and reform' NDR in Scotland. The review aimed to:

- better support business growth and long-term investment
- reflect changing marketplaces
- retain the same level of income (recommendations would be 'revenue neutral').

The review concluded that some form of NDR was still appropriate. The recommendations in the report focused on measures to support economic growth, improve how the system is administered and increase fairness in the system.

In seeking increased fairness, the review recommended that councils' NDR relief for ALEOs should be removed. The review recommended that legislation be changed to remove relief for ALEOs and, in the interim, that the Scottish Government should adjust its funding to recoup an estimated £45 million of ALEO funding from councils. The review recommended this is applied from April 2018.

The Scottish Government has accepted many of the points of the Barclay review, but the recommendation around ALEOs is still being considered. The Accounts Commission will examine ALEOs in more detail in a report to be published in May 2018.

Source: Report of the Barclay Review of Non-Domestic Rates, August 2017

75. Uncertainty means that councils need to prepare for a range of possible scenarios both in terms of costs and funding and different savings options available to them. For example, if councils were to apply a further three per cent increase in council tax in 2018/19 this would raise about £68 million in additional income. In contrast, applying a one per cent increase to staff salaries would cost about £70 million. Even a small proportional increase above this as a result of lifting the public sector pay cap would have further significant costs. Exhibit 23 shows the overall impact of various income and expenditure scenarios on the size of the total funding gap across councils for 2018/19.

Exhibit 23

Council funding gaps scenarios, 2018/19

In the absence of further savings, councils would use around £343 million in 2018/19 if expenditure were to increase by 0.5 per cent and income decrease by 1.5 per cent.

Forecast change to expenditure

Forecast change to income	0%	0.5% ▲	1% ▲	1.5% ▲	2% ▲	2.5% ▲	3% ▲
2.5% ▲	£192	£132	£72	£12	-£48	-£107	-£229
2% ▲	£133	£73	£13	-£47	-£107	-£167	-£288
1.5% ▲	£73	£13	-£46	-£106	-£166	-£226	-£348
1% ▲	£14	-£46	-£106	-£166	-£226	-£285	-£407
0.5% ▲	-£45	-£105	-£165	-£225	-£285	-£345	-£466
0%	-£105	-£165	-£225	-£284	-£344	-£404	-£526
-0.5% ▼	-£164	-£224	-£284	-£344	-£404	-£463	-£585
-1% ▼	-£223	-£283	-£343	-£403	-£463	-£523	-£644
-1.5% ▼	-£283	-£343	-£403	-£462	-£522	-£582	-£704
-2% ▼	-£3[illegible]	[illegible]	[illegible]	-£522	-£582	-£641	-£763
-2.5% ▼	-£4[illegible]	[illegible]	[illegible]	-£581	-£641	-£701	-£822

Funding gap – £million

1.5% reduction in income
+
0.5% increase in expenditure
=
increase funding gap to **£343m** in 2018/19

Source: Audit Scotland funding gap returns

Savings plans should be scrutinised and the impact assessed

76. CIPFA's report on building financial resilience and managing financial stress in local authorities highlighted the importance of planning for savings over at least a three-year period, and the need for robust challenging of plans as part of the scrutiny process.[11] In previous reports, the Accounts Commission has highlighted the need for councils to adopt this practice.

77. Regular updates on forecasts of funding gaps as savings are approved enable councillors to better understand the impact of the savings decisions they are making. However, currently only about half of councils routinely update their three-year financial forecasts as part of their annual budget-setting process.

78. To achieve effective financial management, long-term planning is essential. It is important that councils continue to consider likely funding scenarios and what this means for council services in the longer term as well as the medium term. For councils with lower levels of reserves, financial plans need to be increasingly detailed and robust. This will mean more work for officers and members in clearly identifying savings and assuring themselves that they have the capacity to deliver their intended plans.

79. It is important that savings plans are clear and that the impact on services is understood. Savings should be realistic and achievable. Where funding reductions are passed on to other bodies, such as ALEOs and IJBs, by reducing council contributions to them, it is equally important to assess the impact on service users and communities. Risks associated with income generation initiatives or arising from cuts to services should be explicit and considered by councillors as part of their scrutiny role.

80. Medium-term financial strategies should ensure that both revenue and capital budgets are aligned with corporate plans and that the revenue impact of capital expenditure is understood. Savings from service redesign and other initiatives need to be monitored effectively to ensure that plans and strategies continue to be relevant and accurate.

Does your council have a medium term financial strategy aligned with corporate objectives?

How does annual budget setting link to medium term financial planning?

What impact will savings have on the delivery of services? What are the potential risks?

Longer-term affordability of capital programmes should be kept under review

81. Council capital programmes for 2017/18 are broadly in line with those for 2016/17, with General Fund budgets at about £2.6 billion and HRA budgets at about £800 million.

82. Councils are required to consider the affordability of their capital programmes and any new borrowing before approving them each year. Assessments will include consideration of:

- existing debt levels and servicing costs and how these may increase
- capital reserves available
- impact on running costs, eg reduced overall running costs arising from invest to save initiatives
- additional income streams that can be used to service borrowing

How clearly does the council's capital programme link with the asset management plan and corporate objectives?

- additional funding available, eg Scottish Government funding for NPD projects, additional capital grants in respect of the City Deals (a recent initiative backed by UK and Scottish governments).

83. As revenue resources reduce, and the cost of some debt increases, it is becoming increasingly important for councils to keep the longer-term affordability of their borrowing under review. The need for robust business cases setting out how new capital expenditure will support corporate objectives is key. Capital finance and treasury management are areas covered by regulation and where councils also take professional advice. A key treasury management issue facing councils is the risk around interest rate rises, which makes decisions about the timing of borrowing important. If councils borrow in advance of their need they will incur additional interest costs in the short term. However, if the interest rates go up before councils borrow then they will be faced with paying higher interest rates for the term of any new borrowing. Recently a number of councils have been turning to short-term borrowing to keep their interest costs down but this strategy is not without risk and it is important that councils are clear about these in their plans and reports.

Effective leadership is increasingly important in maintaining financial sustainability

84. The Accounts Commission recognises that the financial challenges facing councils will inevitably mean councillors need to make difficult choices and take decisions that may not sit neatly with the manifestos they were elected on in May 2017. This requires effective political leadership and effective communications. It is essential that councillors work effectively with officers, council partners and other stakeholders to identify and deliver necessary savings. It is important that councils engage with local communities when planning and delivering services and identifying savings. We published a report *Roles and working relationships in councils – Are you still getting it right?* (November 2016) to support councillors in their difficult and challenging role.

What additional training would you like to receive to develop your knowledge and skills in financial scrutiny?

Addressing the underlying demand for services through transformation is key to longer-term sustainability

85. Given the scale of the challenge facing councils, we are of the view that the sustainability of some services will be increasingly dependent on the ability of councils and their partners to address the underlying demand for them. With health and social care integration, for example, much depends on the extent to which resources can be switched from treatment to prevention. Council transformation programmes need to identify and deliver changes of this nature over the longer term. It is important that councils give careful consideration to their capacity to support such change when making savings as part of budget setting.

What measures in the council's corporate and transformational plans are aimed at addressing the underlying demand for services?

86. The extent to which council transformation plans are delivering real changes to the way services are being delivered will be explored further in the second of our local government overview reports planned for publication in April 2018.

Endnotes

1 We published the first of three planned audits on health and social care integration in 2015: *Health and social care integration*, December 2015. Our next national audit in this area will be carried out in 2018/19. Annual audit plans and reports for each IJB are also published on Audit Scotland's website.

2 This excludes income received from arm's-length external organisation (ALEOs) providing services such as leisure services on behalf of the council.

3 *Fiscal issues facing Local Government in Scotland*, Fraser of Allander Institute, March 2017.

4 East Lothian Council, Highland Council (Inverness Jobcentre only), East Dunbartonshire, Midlothian Council and Inverclyde Council (no council stock – therefore no arrears).

5 ALEOs are separate bodies councils create to deliver services that they previously delivered in house.

6 *Building financial resilience: managing financial stress in local authorities*, CIPFA, June 2017.

7 *Major capital investment in councils*, Accounts Commission, March 2013.

8 *Major capital investment in councils: follow-up*, Accounts Commission, January 2016.

9 For more detail on councils' implementation of equal pay, see the Accounts Commission's *Equal pay in Scottish councils* report.

10 This forecast is based on the average of available forecasts.

11 *Building financial resilience: managing financial stress in local authorities*, CIPFA, June 2017.

Local government in Scotland

Financial overview 2016/17

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Prepared by Audit Scotland | November 2017

Local government financial overview 2016/17

Scrutiny tool for councillors

ACCOUNTS COMMISSION

This scrutiny tool captures a number of potential questions for councillors and relates to our report *Local government in Scotland Financial overview 2016/17*. It is designed to provide councillors with examples of questions they may wish to consider to help them better understand their council's financial position and to scrutinise financial performance.

How well informed am I?		
Questions for councillors to consider	**What do I know?**	**Do I need to ask further questions?**
Budget setting (paragraphs 65–68 and 76–80)		
1. Does your council have a medium term financial strategy aligned with corporate objectives?		
2. How does annual budget setting link to medium term financial planning?		
3. How is your council preparing for any further real terms reduction in Scottish Government funding?		
4. If your council plans to raise council tax do you know how much it will raise? How will you communicate and explain the reasons for the rise to constituents?		
5. What impact will savings have on the delivery of services? What are the potential risks?		

Cont.

How well informed am I?		
Questions for councillors to consider	**What do I know?**	**Do I need to ask further questions?**
Financial and savings plans (paragraph 69–80 and 86)		
6. What is your council's financial position? What particular challenges does the council face?		
7. Does your council have a savings plan? What are the options to close future funding gaps?		
8. What measures in the council's corporate and transformational plans are aimed at addressing the underlying demand for some services?		
Reserves (paragraphs 36-48)		
9. What is the councils reserves policy?		
10. What have reserves been used for in recent years? Supporting services and bridging the funding gap or transforming services?		
11. What are the different types of reserves your council holds? Do you know what these can be spent on?		
12. What is the likely use of reserves for 2017/18? How does this compare to forecast funding gaps?		
13. What are the levels of reserves held by your council's IJB? Are these in line with the IJB's reserve policy?		

Cont.

How well informed am I?		
Questions for councillors to consider	**What do I know?**	**Do I need to ask further questions?**
Levels of debt and affordability (paragraphs 49–54)		
14. What share of your council's budget is taken up with interest payments and debt repayment?		
15. What proportion of the council's debt is linked to inflation (ie, subject to indexation)? What does that mean for longer term affordability?		
Budget outturn reports and management commentaries		
16. Do budget monitoring reports clearly explain performance against plans and any changes to plans?		
17. Do management commentaries clearly explain council performance and any changes to plans?		
Financial scrutiny (paragraph 84)		
18. What additional training would you like to receive to develop your knowledge and skills in financial scrutiny?		
Charging for services (paragraphs 23–26)		
19. Does your council have a charging policy? Is this in line with corporate plans and objectives? When was this last reviewed?		
20. What information do you need to be able to explain increases in fees and charges to your constituents?		

Cont.

How well informed am I?		
Questions for councillors to consider	**What do I know?**	**Do I need to ask further questions?**
Exit packages (paragraph 40–42)		
21. Are staff severances in line with the council's workforce plan?		
22. How does the council ensure that councils have the capacity to delivery transformational change?		
23. Do you know the implications of your council's pension liabilities of staff retiring early?		
Capital programmes (paragraphs 31–33 and 65–66)		
24. How clearly does the council's capital programme link with the asset management plan and corporate objectives?		
25. Has non-delivery of the capital programme (ie, slippage) been significant at your council in recent years? Why?		

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Local Government Pension Scheme 2016/17

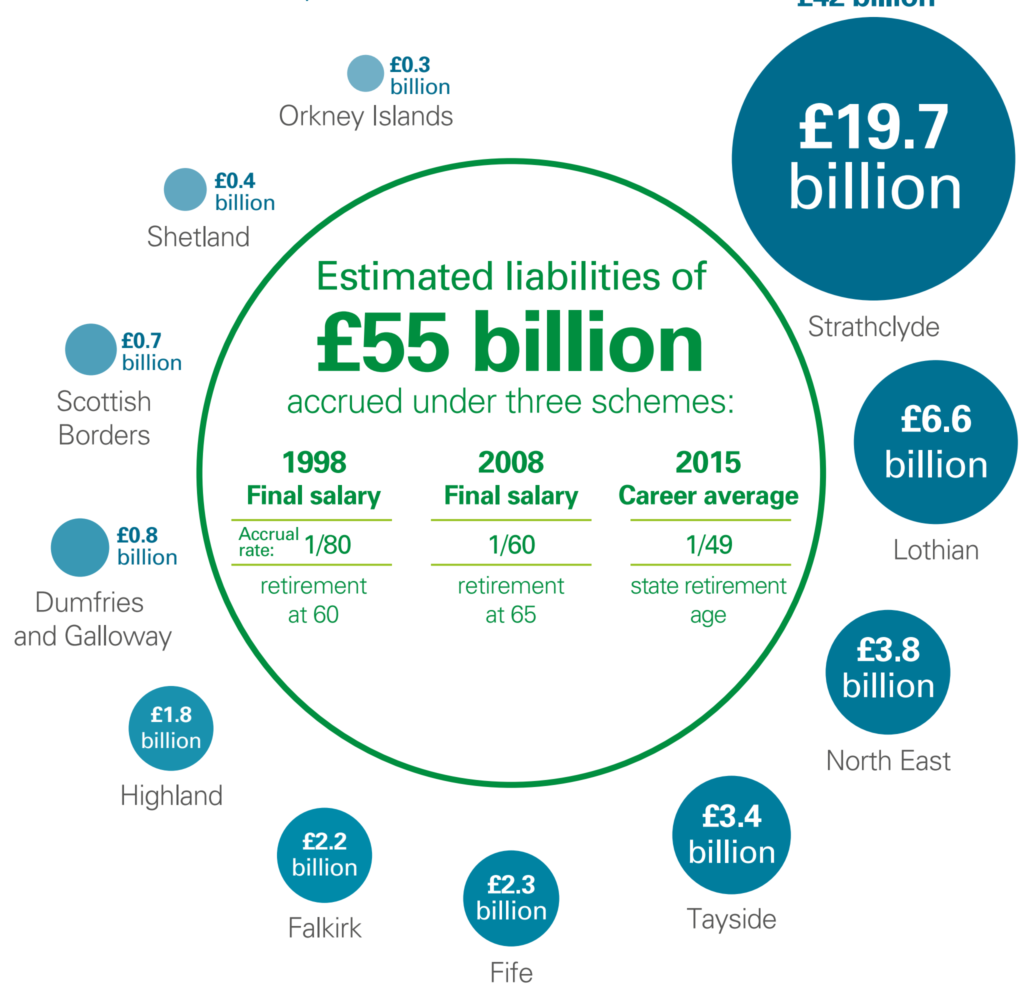
ACCOUNTS COMMISSION

Introduction

1. This supplement accompanies our Local Government in Scotland: Financial Overview 2016/17 and provides an overview of the LGPS in Scotland. We have drawn on the annual reports and accounts of the 11 pension funds administered by councils in Scotland and on the reports of their appointed auditors. In this, the first year of new five year auditor appointments, we are pleased that all 11 pension funds received an unqualified audit opinion on their accounts.

2. It was a good year for pension fund assets, which increased from £34.5 billion to £42 billion. However, the estimated value of liabilities also increased from £42 billion to almost £55 billion (Exhibit 1).

Exhibit 1
LGPS Scotland assets and liabilities, 31 March 2017



Source: Pension Fund Annual Accounts 2016/17

3. The estimated value of LGPS liabilities is in respect of all scheduled and admitted bodies not just councils. Councils have pension liabilities associated with added years awarded on retirement that do not fall on the pension fund and are not included in (Exhibit 1, page 1). Council net pension fund liabilities as at 31 March 2017 were estimated to be £11.5 billion (including unfunded liabilities).

Governance and administration

4. This is the second year of the LGPS 2015 scheme, which links pension benefits to career average earnings (a move away from final salaries under the previous LGPS schemes). We reported last year that pension funds had coped well with the introduction of the scheme and associated governance arrangements, but that the outlook remained challenging.

5. The new governance arrangements introduced under the 2015 scheme are more complex than under the previous LGPS schemes, with more stakeholders being involved. The range of stakeholders is shown in Exhibit 2 (page 3).

6. During 2016/17 the Scottish Scheme Advisory Board reported to the Scottish Minister on the future structure of the LGPS in Scotland. The report has not been made public so any proposed changes to the structure of the LGPS in Scotland are unclear. Irrespective of any proposed changes, a number of pension fund annual reports highlight plans for greater collaboration.

7. A survey[1] undertaken by the Pensions Regulator across all UK public service schemes found improvements in ensuring and demonstrating compliance with the public service code of practice on governance and administration. Auditors confirmed that LPGS pension funds in Scotland had improved arrangements and procedures in this area.

8. During the year the Scottish Public Pensions Agency (SPPA) commissioned KPMG to review governance across all public service pension schemes in Scotland.[2] One of the key issues raised by KPMG is whether there would be benefit in clarifying the role of the LGPS pension boards established under the 2015 LGPS scheme. The remit of LGPS pension boards goes beyond that for other public service schemes, requiring them to consider any pensions matters they deem relevant. The risk is that LGPS boards become overstretched and do not adequately assist scheme managers to comply with regulations and the public service code.

9. Councils rotated the chairs of their pension boards in 2016/17. They have also experienced wider changes in councillor membership of pension committees following the local elections in May 2017. Ensuring that elected members and appointed board members have the requisite skills and knowledge in this highly technical area is an ongoing challenge for pension funds.

Investment performance and pension fund assets

10. Overall, investments performed surprisingly well in a year where several high profile political events including the Brexit referendum and U.S. presidential results, affected investor confidence. The associated fall in the pound resulted in equity prices rising and this contributed to investment returns of around 22 per cent. Exhibit 3 (page 4) shows investment returns for the 11 pension funds.

11. The average return on LGPS investments in Scotland will be strongly influenced by the returns achieved by the larger funds, in particular the Strathclyde fund which accounts for almost 47 per cent of Scotland's £42 billion of LGPS assets.

1 *Public service governance and administration survey – Summary of results and commentary*, Pensions Regulator, May 2017.
2 *Scottish Public Service Pensions Governance Review*, KPMG, February 2017.

Exhibit 2
LGPS governance arrangements

UK

The Pensions Regulator

- Issues codes of practice on governance and administration
- Provides guidance and self assessment tool kits
- Undertakes governance and administration surveys
- Significant breaches of regulation must be reported

Scotland

Scottish Ministers

- Responsible for policy and regulations
- Currently considering a report on the future structure of LGPS

Scottish Public Pensions Agency

- Advise Scottish Ministers on public service policy and regulation
- Commissioned a review of governance in 2016/17

Scottish Scheme Advisory Board

- Advise Scottish Ministers on policy and changes
- Can advise scheme managers and pension boards
- Issued report to Scottish Ministers on future structure of LGPS

11 administering authorities

Pension Committees

- Responsible for decisions on pension fund policy
- Composed of Councillors but may include representatives and advisors
- New members in May 2017

Pension Boards

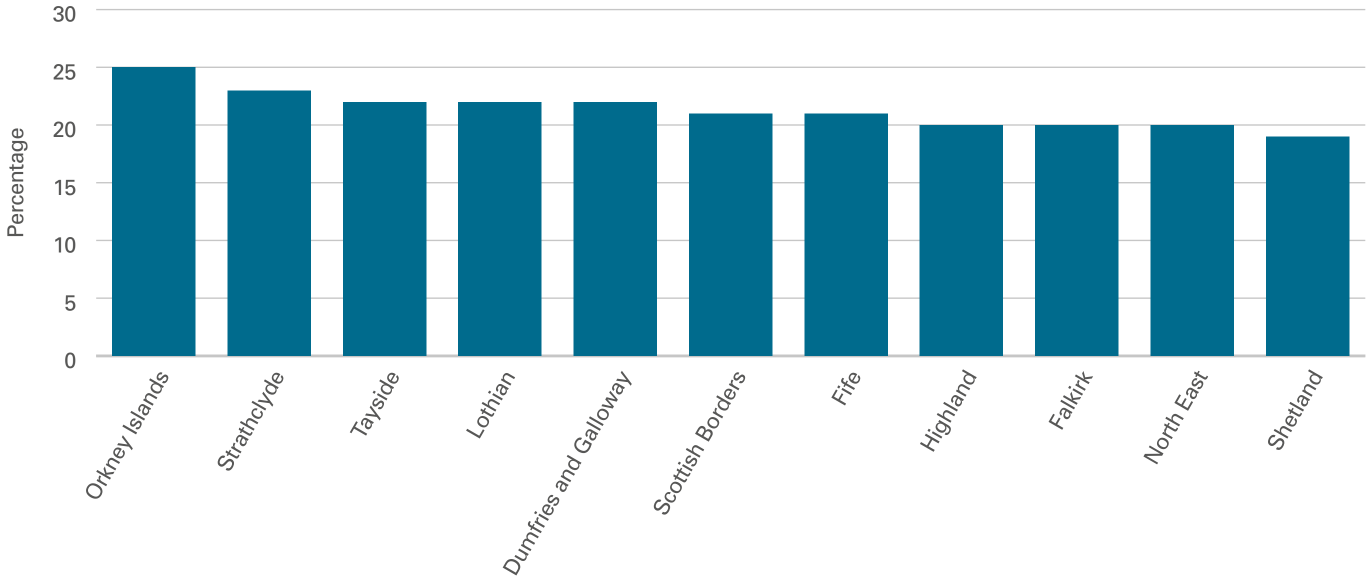
- Supports compliance with law and regulation
- Can consider any matter deemed relevant
- Membership 50:50 employer and union representation
- May request Pension Committee to review decisions

Source: Audit Scotland

Exhibit 3

Return on investments as a percentage of opening investment assets 2016/17

Orkney had the highest investment returns in the year but is the smallest fund.



Source: Pension fund annual accounts 2016/17

12. There has been a continued interest across the pensions sector in the transparency of investment management costs. We welcome developments in this area, as even small reductions in cost arising from a better understanding and level of scrutiny can make a difference when compounded over time. In last year's supplement we expressed our support for full disclosure of costs in pension fund annual reports.

Present value of promised retirement benefits

13. Estimates of the present value of promised retirement benefits or 'pension liabilities' are required under both the pension regulations for funding valuations (forming the basis for employer contributions) and under accounting standards (for disclosure in the pension fund accounts). Funding valuations are carried out every three years whilst estimates of pension liabilities for accounting purposes are updated each year. Pension funds are currently awaiting their final funding valuations for 31 March 2017.

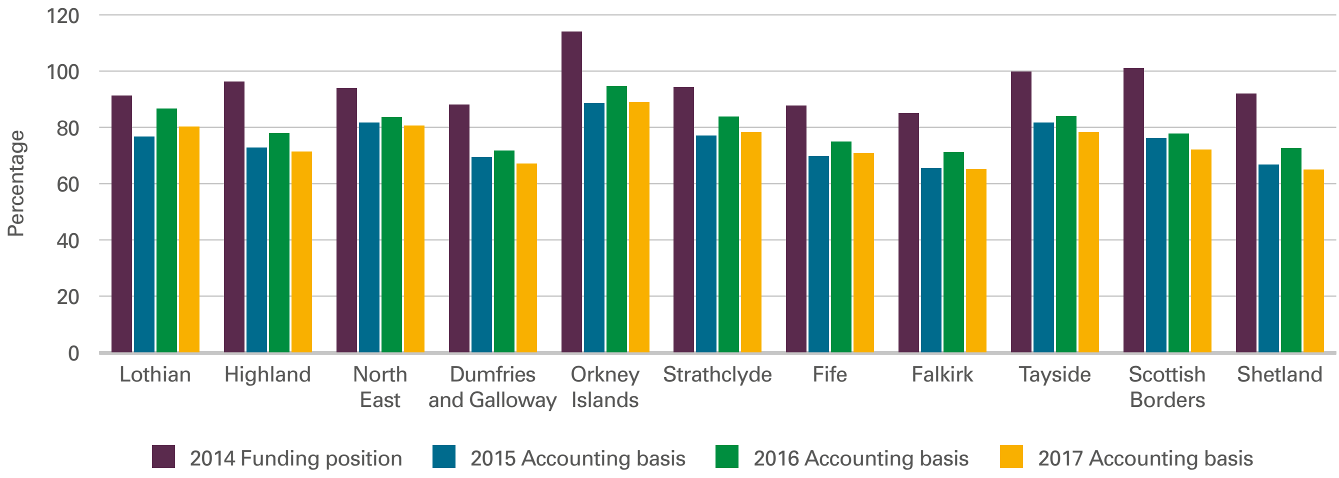
14. Accounting valuations produce higher estimations of liabilities and lower indicative funding levels as a result. Indicative funding levels on an accounting basis for 2017 are broadly similar to those in 2015 (Exhibit 4, page 5).

15. Actuaries will revisit their assumptions and use up to date data to calculate funding valuations as at 31 March 2017. It is this triennial funding valuation that will determine whether employer contributions will need to increase over the next three year period from 2018/19. Any increases for employers will be limited under the cost sharing mechanism in the LGPS 2015.

Exhibit 4

Pension fund assets as a percentage of estimated liabilities 2014 to 2017

Accounting valuations result in lower funding levels than those for funding purposes (2014).



Source: Pension fund annual reports and accounts

Cost control and the employer cost cap

16. Under Section 13 of the Public Service Pension Act 2013 (the 2013 Act) the Government Actuaries Department (GAD) will review the 2017 triennial valuation on behalf of Scottish Ministers. This review will look at the consistency with which actuaries have undertaken valuations in Scotland and their compliance with regulations. The review will also look at the solvency and long term efficiency of the funds and may make recommendations in relation to future cost sharing between employers and active members of the scheme.

17. The cost sharing mechanism in the LGPS 2015 is designed to ensure that the LGPS remains affordable for employers. Under this mechanism (GAD) has established a Scotland wide LGPS employer cost cap of 15.5 per cent. If the cost of providing benefits to members increases by more than two per cent above the employer cost cap then employee contributions and/or benefits will be reviewed.

18. GAD recently undertook a 'dry run' review[3] based on the 2014 funding valuations. This raised no concerns about the solvency or longer term efficiency of the LGPS in Scotland but did raise concerns about inconsistencies in valuations by different actuaries across Scotland's 11 pension funds. We understand that actuaries are looking to address GAD's concerns before reporting in 2018.

3 LGPS SCOTLAND Section 13 Dry Run Report.

Outlook

19. Pension funds face ongoing administrative pressures including those arising from:

- councils severances
- complexities of the new career average scheme.
- guaranteed minimum pension reconcilliations (with HMRC records)
- pensions auto enrolment.

20. To help to reduce their costs and improve services, pension funds are increasingly providing online services to employers and members through programmes of digitalisation. As services evolve pension funds will need to be alert to cyber security risks.

21. New regulatory arrangements for financial markets arising from Markets in Financial Instruments Directive (MIFID 2) will also impact on pension funds from 1 January 2018. MIFID 2 requires all local authorities to be treated as 'retail clients' by their asset managers which would severely limit the ability of pension funds to invest. However, the Financial Conduct Authority rules allow local authorities to opt up to 'professional investor' status allowing fund managers to continue to offer the full range of investments. MIFID 2 was designed to protect the interests of local authorities and care will be needed to ensure that opting up for pension investments does not expose the wider council to increased risks.

22. Delivering investment returns will no doubt remain a challenge for pension funds and pension fund managers. It is unclear to what extent further collaboration between funds will reduce costs and improve performance. It is also unclear whether the Scottish Minister will require pension funds to formally collaborate or propose any structural change following the recent report on the structure of the LGPS in Scotland.

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Local government financial overview 2017

ACCOUNTS COMMISSION

Measures taken by councils to close their funding gaps in 2017/18

Reduce revenue spending

- **Economies and efficiencies**
  - People
    - Numbers - reduced through natural turnover and voluntary severance/redundancy, usually as part of restructure and service redesign.
    - Costs - reduced: overtime, use of agency, consultancy, training and allowances, sickness absence.
  - Premises
    - Asset management plans include estate rationalisation through flexible working and co-location of services with partner bodies in some cases. Energy and water efficiency and reduced cleaning.
  - Supplies and services
    - Procurement and contract management savings. Commissioned services initiatives are often a mix of agreed efficiencies and service reductions.
  - Transport
    - Elimination of unnecessary staff travel and more careful use of own fleet. School transport redesign.
  - Roads
    - LED street lighting. Review of maintenance programmes.
  - Capital financing costs
    - Through use of capital receipts to repay debt, replace borrowing.
- **Reduced and stopped services**
  - Statutory services
    - Tightening of eligibility criteria for care/review of care packages. Reduced frequency of refuse collection.
  - Non statutory services
    - Community wardens, economic regeneration services, public conveniences, bus subsidies.
- **Transformation**
  - Partnerships working/ shared services
    - Integration Joint Boards represent a significant transformational change. The Scottish Government approved £80 million reduction in council contributions to IJBs in 2017/18.
  - Externalisation and third sector
    - Transformation plans often include use of third sector providers as a way of improving services and accessing alternative sources of funding.
  - Digitalisation and customer self service
    - Many councils see increased ICT and digitalisation as a key transformation change.
- **Capitalisation**
  - Increasing capitalisation or reducing revenue contributions to capital could lead to increased costs over the longer term if borrowing goes up.

Increase income

- **Council tax**
  - 24 councils increased council tax charges and 14 removed the 10 per cent discount on second homes.
- **Improve collection performance**
  - Council tax and other income areas.
- **Increase activity/ charges**
  - Planning and building standards, waste disposal, care services, burial charges, car parking, building services, halls and events, sports development and music fees.
- **Introduce new charges for existing services**
  - Public conveniences, archivist services, garden waste.
- **Introduce new services and charges/commercialisation**
  - Advertising and sponsorship, events.
- **Increased capital receipts**
  - From disposal of surplus property. Can be used to meet revenue costs in some instances.

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