APPENDIX 1

SCOTTISH BORDERS COUNCIL

ANNUAL TREASURY MANAGEMENT REPORT YEAR TO 31 MARCH 2016

CONTENTS

1. EXECUTIVE SUMMARY

1.1 This Council is required by regulations issued under the Local Government in Scotland Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2015/16. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

This paper highlights activity in relation to the treasury management function during 2015/16, the Council's strategy with regard to interest rates and future expectations and how the capital expenditure incurred by the Council in 2015/16 was funded. The investment strategy for 2015/16 is summarised in Section 5 and Members are provided with details of how well the treasury function has performed in relation to a set of standard performance indicators.

1.2 During 2015/16, the Council complied with its legislative and regulatory requirements.

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

Table 1	**2015/16 Actual £m**	**2015/16 Estimate £m**	**Variance £m**
Actual Capital Expenditure *(PI-1)*	**45.0**	**50.7**	**(5.7)**
Total Capital Financing Requirement (CFR) ** *(PI-2)*	**258.0**	**266.6**	**(8.6)**
(Under)/Over Gross Borrowing against the CFR *(PI-6)* ***	**(56.6)**	**(57.2)**	**(0.6)**

** Revised estimate, approved by Council on 17 December 2015 as part of the mid-year report*
*** The CFR for this calculation includes current capital expenditure to 31 March 2015*
**** The CFR for this calculation includes the current and two future years projected capital expenditure.*

1.4 No additional long term borrowing for a capital purpose was undertaken during 2015/16 and the statutory borrowing limit (the authorised limit) was not breached.

1.5 The economic environment during the 2015/16 financial year continued to remain challenging, with low investment returns.

2. COUNCIL'S CAPITAL EXPENDITURE AND FINANCING 2015/16

2.1 CAPITAL EXPENDITURE *(Prudential Indicator 1)*

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

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

b) The actual capital expenditure forms one of the required prudential indicators. **Table 2** below summarises the final out-turn position compared with the estimate reported to Council in the mid-year report.

Table 2	**2015/16 Actual £m**	**2015/16 Estimate £m**	**Variance £m**
Place	33.7	33.5	0.2
People	7.1	11.9	(4.8)
Chief Executive	4.2	5.3	(1.1)
Total Capital Expenditure *(PI-1)*	**45.0**	**50.7**	**(5.7)**

c) The final capital expenditure for 2015/16 was lower than projected as a result of delays in expenditure on a number of projects, including School and Social Care infrastructure, specifically relating to Kelso High School (£973k), Duns Primary School (£1,154k), and Residential Care Homes (£756k). Delays in expenditure in Road and Bridge schemes (£454k) and Waste Management Infrastructure (£411k) also contributed to this variance.

The specific drivers for each of the movements have been disclosed in the regular monitoring reports to the Executive throughout 2015/16 and in the out-turn report presented in 7 June 2016.

2.2 FINANCING THE CAPITAL PROGRAMME

a) Capital Expenditure may either be financed:

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

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

b) **Table 3** below summarises the main funding elements of the 2015/16 capital expenditure.

Table 3	**2015/16 Actual £m**	**2015/16 Estimate £m**	**Variance £m**
Capital Expenditure	45.0	50.7	(5.7)
Other Relevant Expenditure *	1.4	1.0	0.4
Total Expenditure	**46.4**	**51.7**	**(5.3)**
Financed by:			
Capital Grants & Other Contributions	29.0	30.1	(1.1)
SBC Revenue Funding	1.0	0.0	1.0
Capital Fund/Capital Receipts	1.5	1.7	(0.2)
Plant & Vehicle Fund	2.5	2.5	0.0
Total identified finance	**34.0**	**34.3**	**(0.3)**
Net Financing Need for the Year	**12.4**	**17.4**	**(5.0)**

** This consists of net lending to the National Housing Trust (NHT) during 2015/16 of £1.357m.*

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

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

a) The Council's underlying need to borrow for capital expenditure is termed the **Capital Financing Requirement (CFR)** and is a key prudential indicator. The CFR results from the capital activity of the Council and the resources that have been used to pay for the capital spend. It represents the 2015/16 unfinanced capital expenditure (see **Table 3** in section 2.2 (b)), and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

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

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

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

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

d) The extent to which the Council is under/over borrowed at 31 March 2016 is calculated by comparing actual external debt against the CFR and is shown in **Table 4** below. It includes "Other long term liabilities", such as PFI and leasing schemes on the balance sheet. These increase the Council's borrowing need, however, as no borrowing is actually required against these schemes, these amounts have been deducted in **Table 4**.

Table 4	**31 March 2016 Actual £m**	**31 March 2016 Estimate £m**	**Variance £m**
CFR *(PI-2)**	**258.0**	**266.6**	**(8.6)**
Less: Other long term liabilities **	54.7	54.3	0.4
Underlying borrowing requirement	**203.3**	**212.3**	**(9.0)**
External Borrowing at 31/3/16	170.8	171.6	(0.8)
(Under)/Over borrowing	**(32.5)**	**(40.7)**	**(8.2)**

**The CFR for this calculation includes current capital expenditure to 31 March 2016*
***PPP/PFI/Finance Lease balances*

e) The reason for the decrease in the level of under-borrowing, compared to that projected, is that the Council had sufficient positive cash-flow to fund expenditure without borrowing. In addition, the actual level of capital expenditure for 2015/16 was less than the projected value in the mid-year report. The decision not to borrow at this point was driven by the following considerations:

(i) There remains a significant differential between borrowing and investment rates, which results in a higher percentage cost of carrying borrowed financing that is sitting as surplus cashflow.

(ii) During 2015/16 the Council retained sufficient cash flow to meet its outgoing capital requirements.

(iii) The number of counterparties meeting the Council's investment strategy criteria remains low.

(iv) The extension of the forecasts on low interest rates means that the long term interest rate position was not expected to change significantly in the next 12 months.

3 TREASURY MANAGEMENT ACTIVITY

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

a) In order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year (2015/16) plus the estimates of any additional capital financing requirement for the current (2016/17) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2015/16. The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with this prudential indicator.

Table 5	**31 March 2016 Actual £m**	**31 March 2016 Estimate £m**	**Variance £m**
Fixed rate funding			
PWLB	127.6	127.6	-
Market	-	-	-
Variable rate funding			
Market *	43.2	44.0	0.8
External Borrowing	**170.8**	**171.6**	**0.8**
Other long term liabilities **	54.7	54.3	(0.4)
Total Debt	**225.5**	**226.0**	**0.5**
CFR (inc. next 2 year estimates)	282.1	283.2	1.1
(Under)/Over Gross Borrowing against the CFR *(PI-6)*	**(56.6)**	**(57.2)**	**(0.6)**

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

b) Council deposits were made on a short term basis throughout 2015/16.

c) There was no rescheduling of debt during 2015/16. The low rates of interest available on investments favoured the use of cash and other sources of finance rather than increased borrowing.

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

a) The **Operational Boundary** and the **Authorised Limit** are indicators which are intended to act as limits to the overall level of borrowing activity. The Authorised Limit represents the maximum limit beyond which borrowing is prohibited. The Operational Boundary represents the level of external borrowing that the Council is expected to operate within. **Table 6** compares the External Debt position with these indicators and demonstrates that the Council has not breached either limit during 2015/16.

Table 6	**31 March 2016 Actual £m**	**Authorised Limit** *(PI-8)* **£m**	**Variance £m**	**Operational Boundary** *(PI-7)* **£m**	**Variance £m**
Total Gross Borrowing	**225.5**	**319.1**	**(93.6)**	**270.4**	**(44.9)**

3.3 MATURITY PROFILE OF EXTERNAL DEBT

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

Table 7	**31 March 2015 £m**
Under 12 months	-
12 months and within 5 years	0.7
5 years and within 10 years	13.2
Over 10 years	156.9
Total	**170.8**

4. INTEREST RATE MOVEMENTS AND EXPECTATIONS

4.1 TREASURY STRATEGY FOR 2015/16

a) The expectation for interest rates within the treasury management strategy for 2015/16 anticipated low but rising Bank Rate, (starting in quarter 1 of 2016), and gradual rises in medium and longer term fixed borrowing rates during 2016/17. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates. In this scenario, the treasury strategy was to postpone borrowing to avoid the cost of holding higher levels of investments and to reduce counterparty risk.

b) The sharp volatility in equity markets during the year was reflected in sharp volatility in bond yields. However, the overall dominant trend in bond yields since July 2015 has been for yields to fall to historically low levels as forecasts for inflation have repeatedly been revised downwards and expectations of increases in central rates have been pushed back.

c) The comparison of the annual *average* percentage interest rates to projections within the 2015/16 strategy is set out in **Table 8** below.

Table 8	**Bank Rate**	**PWLB Rates %**		
	%	**5 year**	**25 year**	**50 year**
2015/16 Estimate	0.5	2.6	4.0	4.0
2015/16 Actual	0.5	2.3	3.6	3.4
Variance	**-**	***0.3***	***0.4***	***0.6***

4.2 THE ECONOMY AND INTEREST RATES – 2015/16

a) Market expectations for the first increase in Bank Rate moved considerably during 2015/16, starting at quarter 3 2015 but soon moving back to quarter 1 2016. However, by the end of the year, market expectations had moved back radically to quarter 2 2018 due to many fears including concerns that China's economic growth could be heading towards a hard landing; the potential destabilisation of some emerging market countries particularly exposed to the Chinese economic slowdown; and the continuation of the collapse in oil prices during 2015 together with continuing Eurozone growth uncertainties.

b) These concerns have caused sharp market volatility in equity prices during the year with corresponding impacts on bond prices and bond yields due to safe haven flows. Bank Rate, therefore, remained unchanged at 0.5% for the seventh successive year. Economic growth (GDP) in 2015/16 has been disappointing with growth falling steadily from an annual rate of 2.9% in quarter 1 2015 to 2.1% in quarter 4.

c) The sharp volatility in equity markets during the year was reflected in sharp volatility in bond yields. However, the overall dominant trend in bond yields since July 2015 has been for yields to fall to historically low levels as forecasts for inflation have repeatedly been revised downwards and expectations of increases in central rates have been pushed back. In addition, a notable trend in the year was that several central banks introduced negative interest rates as a measure to stimulate the creation of credit and hence economic growth.

d) The ECB commenced a full blown quantitative easing programme of purchases of Eurozone government and other bonds starting in March at €60bn per month. This put downward pressure on Eurozone bond yields. There was a further increase in this programme of QE in December 2015.

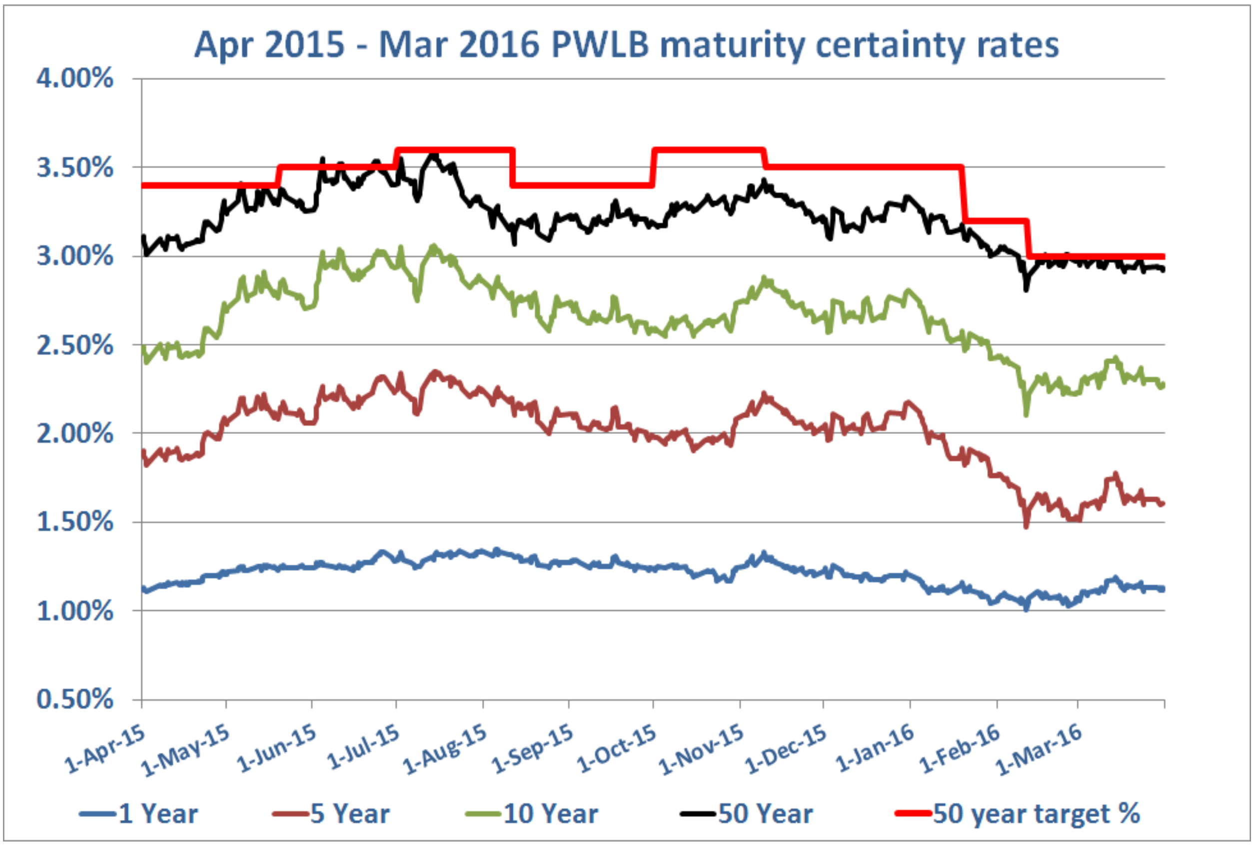
e) In America, the economy has continued to grow healthily on the back of resilient consumer demand. The first increase in the central rate occurred in December 2015 since when there has been a return to caution as to the speed of further increases due to concerns around the risks to world growth.

f) The UK elected a majority Conservative Government in May 2015, removing one potential concern but introducing another due to the promise of a referendum on the UK remaining part of the EU. The government maintained its tight fiscal policy stance but the more recent downturn in expectations for economic growth has made it more difficult to return the public sector net borrowing to a balanced annual position within the period of this parliament.

4.3 BORROWING RATES IN 2015/16

a) **PWLB Borrowing Rates**

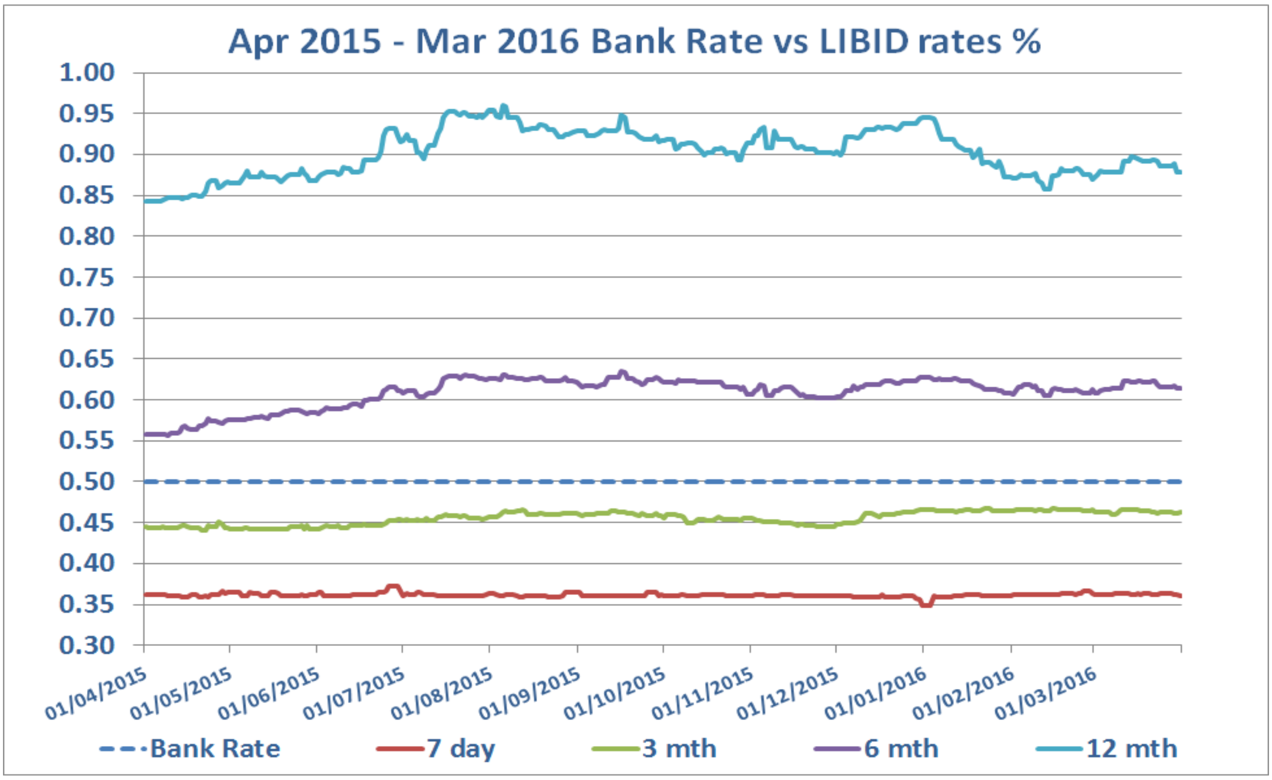
Chart 1 below shows how PWLB certainty rates have fallen to historically very low levels during the year.



4.4 INVESTMENT RATES IN 2015/16

a) Bank Rate remained at its historic low of 0.5% throughout the year; it has now remained unchanged for seven years. Market expectations as to the timing of the start of monetary tightening started the year at quarter 1 2016 but then moved back to around quarter 2 2018 by the end of the year. Deposit rates remained depressed during the whole of the year, primarily due to the effects of the Funding for Lending Scheme and due to the continuing weak expectations as to when Bank Rate would start rising.

b) **Chart 2** below illustrates the change in the Investment Rates certainty maturity rates, for a selection of maturity periods, throughout 2015/16.



5. INVESTMENT OUTTURN FOR 2015/16

5.1 INVESTMENT OBJECTIVES

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

b) The **primary objectives** of the Council's investment strategy are:
   (i) the safeguarding or **security** of the repayment of the principal and interest of investments on a timely basis;
   (ii) ensuring adequate **liquidity** within the Council; and
   (iii) investment **yield** or return.

c) The Council will ensure:
   (i) It maintains a policy covering the categories of investment types it will invest in, the criteria for choosing investment counterparties with adequate security, and the monitoring of their security; and
   (ii) It has sufficient liquidity in its investments. For this purpose it sets out procedures for determining the maximum periods for which funds may prudently be committed. The Council's Prudential Indicators cover the maximum period over which sums can be invested.

5.2 INVESTMENT ACTIVITY

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

5.3 CURRENT INVESTMENT POSITION

a) The total value of investments/deposits for the Council at 31 March 2016 was £19.4m. Cash was held on a short term basis throughout 2015/16 with major banks and various money market funds (the latter having a credit rating of AAA).

6 TREASURY PERFORMANCE INDICATORS

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

6.1 DEBT PERFORMANCE INDICATORS

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

a) **Average 'Pool Rate'** charged by the Loans Fund compared to Scottish Local Authority average Pool Rate. Target is to be at or below the Scottish Average for 2015/16.

The Council's loans fund pool rate for 2015/16 was 4.62%. The Scottish Local Authority average "pool rate" for 2015/16 is not yet available at the time of writing, but was 4.44% in 2014/15 and is not expected to be materially different for 2015/16.

b) **Average rate movement year on year**. Target is to maintain or reduce the average borrowing rate for the Council versus 2014/15. The Council's pool rate of 4.62% for 2015/16 was 0.03% lower than the reported Council's rate of 2014/15.

6.2 INVESTMENT PERFORMANCE INDICATORS

a) Security

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

(ii) The actual performance of this indicator was 0.019% **historic risk,** slightly below the benchmark, if overnight deposits with the Council's own bank, the Bank of Scotland, are taken into account. The Bank of Scotland has only a single A credit rating and the lower the credit rating, the higher the risk of default. Excluding Bank of Scotland deposits, the risk of default on deposits was 0.0024%, which is far below the benchmark level. This was achieved by placing deposits with higher rated counterparties, which have lower historic risk of default, and by utilising only overnight or short term notice accounts.

(iii) During 2015/16, money was deposited in accounts on a short term basis, not exceeding 3 months.

(iv) *In July 2016, Standard & Poor's downgraded the Council's bank, Bank of Scotland from a stable to a negative outlook. However, this was in line with downgrades of other main UK banks. Like other main UK banks, the long and short term outlook for Bank of Scotland have been graded as A and A-1 respectively. This represents the minimum counter party grading accepted by the Council per the Treasury Management Strategy. This position is being closely monitored.*

b) Liquidity

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

(ii) This indicator was adhered to throughout all of 2015/16.

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

(iv) The weighted **average life for 2015/16 was 0.01 years**, well below the 0.5 year target.

c) Yield

The target yield is to have internal returns on cash investment above the 7 day LIBID rate. The return for 2015/16 averaged 0.40%, compared against an average 7 day LIBID rate for the year to 31 March 2015 of 0.36%.

2014/15 comparison figures for average internal returns and 7 day LIBID were 0.37% and 0.35% respectively. Therefore, 2015/16 returns showed a continued return in excess of target and an improved return from the previous year.

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

6.3 IMPACT ON REVENUE BUDGET

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

This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue funding for the Council. The comparison of the revised estimate approved in the 2015/16 mid year report to the outturn as at 31 March 2016 is as follows:

Table 9	**Actual**	**Estimate**
Ratio of financing costs to net revenue stream *(PI-3)*	**%** **8.65**	**%** **8.9**

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

Table 10	**2015/16 Outturn £m**	**2015/16 Mid-Year Estimate £m**	**Variance (Under) /Over £m**
Interest on Borrowing	12.3	12.0	0.3
Investment Income	(0.1)	(0.1)	-
Capital Repayments	8.7	8.8	(0.1)
Total Loan Charges	**20.9**	**20.7**	**0.2**

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

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

a) The Treasury Indicators (TIs) are shown in **Table 11** below. The Council remained well within these Indicator limits throughout 2015/16.

Table 11	**2015/16 Revised Indicator**		**2015/16 Actual as at 31 March 2016**
Upper limits – Debt with fixed and variable interest rates			
Upper limits on fixed interest rates *(TI-1)*	239.1		271.6
Upper limits on variable interest rates *(TI-2)*	83.7		95.1
Maturity Structure of borrowing			
	Upper *(TI-3)*	**Lower** *(TI-4)*	**Actual**
Under 12 months	20%	0%	0.00%
12 months to 2 years	20%	0%	0.00%
2 years to 5 years	20%	0%	0.41%
5 years to 10 years	20%	0%	7.73%
10 years and above	100%	20%	91.86%
Prudential limits for principal sums invested *(TI-5)*			
Cash Deposits < 12 months	100%		100%
Cash Deposits > 12 months	20%		0%

ANNEX A

Indicator Reference	Indicator	Page Ref.	2015/16 Original estimate	2015/16 Revised estimate	2015/16 Actual
PRUDENTIAL INDICATORS					
Capital Expenditure Indicator					
PI-1	Capital Expenditure	3	£58.4m	£50.7m	£45.0m
PI-2	Capital Financing Requirement (CFR)	6	£276.1m	£261.8m	£258.0m
Affordability Indicator					
PI-3	Ratio of Financing Costs to Net Revenue	16	10.0%	8.9%	8.82%
PI-4	Incremental Impact of Capital Investment Decisions on Council Tax	N/A	0.00	0.50	0.00
External Debt Indicators					
PI-5	Actual Debt	8	£247.3m	£225.9m	£225.5m
PI-7a	Operational Boundary (inc. Other Long Term Liabilities)	9	£251.1m	£239.0m	£270.4m
PI-7b	Operational Boundary (exc. Other Long Term Liabilities)	9	£196.9m	£182.5m	£215.7m
PI-8a	Authorised Limit (inc. Other Long Term Liabilities)	9	£323.4m	£304.0m	£319.1m
PI-8b	Authorised Limit (exc. Other Long Term Liabilities)	9	£269.7m	£242.8m	£264.4m
Indicators of Prudence					
PI-6	(Under)/Over Gross Borrowing against the CFR	8	(£37.0m)	(£52.3m)	(£56.6m)
TREASURY INDICATORS					
TI-1	Upper Limit to Fixed Interest Rates based on Net Debt	16	£251.1m	£239.1m	£270.4m
TI-2	Upper Limit to Variable Interest Rates based on Net Debt	16	£87.9m	£83.7m	£94.6m
TI-3 & TI-4	Maturity Structure of Fixed Interest Rate Borrowing 2013/14	16	**Upper**		**Lower**
	Under 12 months		20%		0%
	12 months to 2 years		20%		0%
	2 years to 5 years		20%		0%
	5 years to 10 years		20%		0%
	10 years and above		100%		20%
TI-5	Maximum Principal Sum invested greater than 364 days	16	20%	20%	20%