APPENDIX 1

SCOTTISH BORDERS COUNCIL

TREASURY MANAGEMENT MID-YEAR REPORT 2017/18

1. BACKGROUND

a) Treasury management is defined 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".

b) The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations is to ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing security and adequate liquidity, before considering optimising investment return.

c) 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 the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion, where favourable conditions exist, any debt previously drawn may be restructured to meet Council risk or cost objectives.

d) **Annex A** contains a summary of the updated Prudential and Treasury Management Indicators for 2017/18 as highlighted throughout this report.

2 ECONOMIC POSITION

2.1 ECONOMIC UPDATE *(from Capita Asset Services)*

UK. After the UK economy surprised on the upside with strong growth in 2016, growth in 2017 has been disappointingly weak; quarter 1 came in at only +0.3% (+1.7% y/y) and quarter 2 was +0.3% (+1.5% y/y) which meant that growth in the first half of 2017 was the slowest for the first half of any year since 2012. The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling after the 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 75% 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. However, this sector only accounts for around 11% of GDP so expansion in this sector will have a much more muted effect on the average total GDP growth figure for the UK economy as a whole.

The Monetary Policy Committee (MPC) meeting of 14 September 2017 surprised 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. The Bank of England Inflation Reports during 2017 have clearly flagged up that they 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. Inflation actually came in at 2.9% in August, (this data was released on 12 September), and so the Bank revised its forecast for the peak to over 3% at the 14 September meeting MPC. This marginal revision can hardly justify why the MPC became so aggressive with its wording; rather, the focus was on an emerging view that with unemployment falling 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 increasing globalisation. This effectively means that the UK labour faces competition from overseas labour e.g. in outsourcing work to third world countries, and this therefore depresses the negotiating power of UK labour. 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 would be inflationary over the next few years.

It therefore looks very likely that the MPC will increase Bank Rate to 0.5% in November or, if not, in February 2018. The big question after that will be whether this will be a one off increase or the start of a slow, but regular, increase in Bank Rate. As at the start of October, short sterling rates are indicating that financial markets do not expect a second increase until May 2018 with a third increase in November 2019. However, some forecasters are flagging up that they expect growth to improve significantly in 2017 and into 2018, as the fall in inflation will bring to an end the negative impact on consumer spending power while a strong export performance will compensate for weak services sector growth. If this scenario were to materialise, then the MPC would have added reason to embark on a series of slow but gradual increases in Bank Rate during 2018. 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 years will pan out.

b) **EU.** Economic growth in the EU, (the UK's biggest trading partner), has 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 now looks to have gathered ongoing substantial strength and momentum thanks to this stimulus. GDP growth was 0.5% in quarter 1 (2.0% y/y) and 0.6% in quarter (2.3% 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 August inflation was 1.5%. It is therefore unlikely to start on an upswing in rates until possibly 2019.

c) **USA.** Growth in the American economy has been 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%, resulting in an overall annualised figure of 2.1% for the first half year. Unemployment in the US has also fallen to the lowest level for many years, reaching 4.4%, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has started on a gradual upswing in rates with 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 more increases in 2018. At its June meeting, the Fed strongly hinted that it would soon begin to unwind its $4.5 trillion balance sheet holdings of bonds and mortgage backed securities by reducing its reinvestment of maturing holdings.

d) **Chinese 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.

e) **Japan** is 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.

2.2 ECONOMIC OUTLOOK

The overall balance of risks to economic recovery in the UK is currently to the downside but huge variables over the coming few years including the timing of, and what final form Brexit will look like when agreed with the EU..

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- UK economic growth and increases in inflation are weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU and US.
- Geopolitical risks in Europe, the Middle East and Asia, which could lead to increasing safe haven flows.
- A resurgence of the Eurozone sovereign debt crisis.
- Weak capitalisation of some European banks.
- Monetary policy action failing to stimulate sustainable growth and to get inflation up considerably to around monetary policy target levels.

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

- The pace and timing of increases in the Fed. Funds Rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
- UK inflation returning to significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

2.3 INTEREST RATE FORECAST

a) Table 1 summarises the latest interest rate forecast from the Council's treasury adviser, Capita Asset Services.

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Bank rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.50%	1.60%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%
50yr PWLB rate	2.70%	2.70%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%

***Source**: Capita Asset Services – October 2017.*

b) Capita Asset Services undertook its last review of interest rate forecasts on 9 August after the quarterly Bank of England Inflation Report. There was no change in MPC policy at that meeting. However, the MPC meeting of 14 September revealed a sharp change in sentiment whereby a majority of MPC members said they would be voting for an increase in Bank Rate "over the coming months". It is therefore possible that there will be an increase to 0.5% at the November MPC meeting. If that happens, the question will then be as to whether the MPC will stop at just withdrawing the emergency Bank Rate cut of 0.25% in August 2016, after the result of the EU withdrawal referendum, or whether they will embark on a series of further increases in Bank Rate during 2018.

3 TREASURY MANAGEMENT POLICY STATEMENT - UPDATE

a) The Treasury Management Policy Statement (the Statement) was approved by Council in April 2010. There have been no policy changes to the Statement. The details in this report update the position in light of updated economic position and budgetary changes.

b) Treasury Management Strategy Statement (TMSS) for 2017/18 was approved by Council on 9 February 2017. There were no policy changes to the Statement. The details in this report update provides an update on Treasury Management activities, including Prudential and Treasury Management Indicators.

4 COUNCIL'S CAPITAL EXPENDITURE AND FINANCING 2017/18

4.1 This part of the report is structured to update:

- The Council's capital expenditure plan.
- How these plans are being financed.
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow, and
- Compliance with the limits in place for borrowing activity.

4.2 CAPITAL EXPENDITURE
(Prudential Indicator (PI-1)

a) The original capital plan for 2017/18 was approved on 09 February 2017. **Table 2** shows the current budgets for capital expenditure compared to the original estimates used in the Treasury Management Strategy report for 2017/18 which included net budget timing movements from prior years.

Table 2	**2017/18 Original Budget £m**	**2017/18 Current Approved Budget [1] £m**	**Variance Original to Current Approved £m**
Assets & Infrastructure	24.7	28.5	3.8
Other Corporate Services	2.7	4.0	1.3
Children & Young People	13.5	16.8	3.3
Culture & Sport	1.8	2.1	0.3
Economic Development	3.1	8.3	5.2
Emergency & Unplanned Schemes	0.3	-	(0.3)
Health & Social Care	0.1	0.4	0.3
Planned Phasing Adjustments	(4.0)	(3.4)	0.6
Total Capital Expenditure *(PI-1)*	**42.2**	**56.7**	**14.5**

[1] **Executive Committee 21 November 2017**

b) The current approved budget for 2017/18 is higher than the original budget due to adverse timing movements from February 2017 to 31 March 2017 in areas of the capital plan. Detailed explanations of the movements within the planned expenditure have been reported in the ongoing monitoring reports, the last of which was to the Executive Committee on 21 November 2017. The key drivers for the 2016/17 changes in Table 2 are:

- Assets & Infrastructure – Road and Transport Infrastructure. Total additions to budget amount to £1.86m. Also increases to the Land and Property Infrastructure projects total £0.63m
- Other Corporate Services budget has increased by £2.85m, principally from the inclusion of additional £2.64m ICT Transformation budget.
- Children & Young People – School Estate budget increases amount to £3.32m. The key increases in estimated expenditure result from a net timing movement relating to the construction of Broomlands and Duns Primary Schools
- Economic Development – Additional budget as a timing movement between financial year amounting to £3.6m relates to the Hawick Regeneration project.

4.3 FINANCING OF THE CAPITAL PROGRAMME

a) **Table 3** on the following page draws together the main funding elements of the capital expenditure plans (see 4.2 above), comparing the original components of the funding strategy to those of the latest approved budget for the 2017/18 capital programme.

Table 3	**2017/18 Original Budget £m**	**2017/18 Current Approved Budget [1] £m**	**Variance - Original to Current Approved £m**
Capital Expenditure (PI-1)	42.2	56.7	14.5
Other Relevant Expenditure	2.0	0.4	(1.6)
Total Expenditure	**44.2**	**57.1**	**12.9**
Financed by:			
Capital receipts	(1.9)	(1.9)	-
Capital from Revenue (CFCR)	(0.3)	(0.4)	(0.1)
Developer Contributions	(1.4)	(1.7)	(0.3)
Govt. General Capital Grant	(14.5)	(15.4)	(0.9)
Govt. Specific Capital Grant	(3.1)	(9.3)	(6.2)
Other Grants & Contributions	(0.9)	(2.3)	(1.4)
Replacement Funds	(2.0)	(1.3)	0.7
Total Financing	**(24.1)**	**(32.3)**	**(8.2)**
Net Financing Need for the Year	***20.1***	***24.8***	***4.7***

[1] **Executive Committee 21 November 2017**

b) The increase in overall financing need is primarily driven by the additional projected capital expenditure as detailed in table 2, above. Total expenditure is also impacted by a re-profiling of the timing of “Other Relevant Expenditure” which relates to lending to the National Housing Trust project delivered by Bridge Homes LLP amounts to a movement of £1.6m The impact on net financing need by this increase in expenditure of £13.0m in total, has been negated somewhat by a material increase in Scottish Government

Specific Grants of £6.2m, principally relating to the Hawick Regeneration and Early Learning and Childcare projects. Additional increases in other funding streams as detailed above has also increased total funding, thereby resulting in an increase to the net financing need of £4.7m. .

4.4 CAPITAL FINANCING REQUIREMENT AND EXTERNAL DEBT INDICATORS

CAPITAL FINANCING REQUIREMENT (CFR) *(PI-2)*

i) **Table 4** below shows the CFR, which is the underlying need to incur external borrowing for a capital purpose.

ii) The CFR has been re-calculated in light of the changes to the capital plan and the fixed asset and reserve valuations in the Council's accounts for the year ending 31 March 2017. Accounting transactions relating to the Waverley Railway repayment omitted from original estimate assumptions account for the variance in the CFR as detailed below.

Table 4	**2017/18 Original estimate £m**	**2017/18 Revised estimate £m**	**Variance £m**
CFR * *(PI-2)*	**293.1**	**301.2**	**8.1**

The CFR for this calculation includes current capital expenditure assumptions to 30 September 2017

ACTUAL EXTERNAL DEBT *(PI-5)*

iii) Projected external debt for 2017/18 is shown in **Table 5** below and is estimated to remain within the operational boundary.

iv) **Table 5** also compares the current projected external borrowing estimate with the estimate in the Annual Strategy. In cash terms, the borrowing figure is higher than originally projected in line with the increased net financing need as detailed above. A variance in cash levels held at the year-end compared to those projected also impact on the variance below.

v) Additional borrowing amounting to £10.0m has been undertaken in April 2017. Further borrowing of £5.2m is anticipated during the remainder of the year.

Table 5	**2017/18 Original estimate £m**	**2017/18 Current Approved Budget £m**	**Variance £m**
Borrowing	192.4	198.3	5.8
Other long-term liabilities	72.9	72.9	-
Total External Debt (PI-5)	**265.4**	**271.2**	**5.8**

(UNDER)/OVER BORROWING AGAINST CFR *(PI-6)*

vi) A key control over treasury activity is a prudential indicator to ensure that, over the medium term, borrowing will only be for a capital purpose. Net external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2017/18 and next two financial years. This allows some flexibility for limited early borrowing for future years.

vii) **Table 6** compares the prudential indicator for (under)/over borrowing against CFR versus the updated estimate for the year end and shows that the Council's actual debt levels are well within its capital financing requirement. This is primarily driven by the tactical measures which use the Council's surplus cash-flows to finance capital expenditure minimising the need enter into additional debt financing arrangements.

Table 6	**2017/18 Original estimate £m**	**2017/18 Current Approved Budget £m**	**Variance £m**
Gross External Debt	**265.4**	**271.2**	**5.8**
CFR *	291.2	296.3	5.1
(Under)/Over Borrowing against CFR *(PI-6)*	**(25.8)**	**(25.1)**	**0.7**

** The CFR for this calculation includes the current and two future years projected capital expenditure.*

viii) No difficulties are envisaged for the current or future years in complying with this prudential indicator.

AUTHORISED LIMIT AND OPERATIONAL BOUNDARY *(PI-7 and PI-8)*

ix) Two further prudential indicators control the overall level of borrowing. These are:

(i) The **Authorised Limit** which represents the limit beyond which borrowing is prohibited and the expected maximum borrowing need for the Council. It needs to be set and revised by Members. The Authorised Limit is the statutory limit determined under the Local Government in Scotland Act 2003.
(ii) The **Operational Boundary** which shows the expected operational debt position for the period.

x) **Table 7** below shows revised estimates for the debt indicators for the 2017/18 financial year and compares them with the original estimates shown in the 2017/18 Treasury Management Strategy Report.

Table 7	**2017/18 Original estimate £m**	**2017/18 Revised estimate £m**	**Variance £m**
Gross External Debt *(PI-5)*	**265.4**	**271.2**	**5.8**
Authorised Limit inc. Long Term Liabilities*(PI-8a)*	**343.6**	**348.0**	**4.4**
Variance to External Debt Estimate	*78.2*	*76.9*	*(1.4)*
Operational Boundary inc. Long Term Liabilities *(PI-7a)*	**285.0**	**289.5**	**4.5**
Variance to External Debt Estimate	*19.6*	*18.3*	*(1.3)*

4.5 DEBT RESCHEDULING

Debt rescheduling opportunities continue to have been limited in the current economic climate. No debt rescheduling was undertaken during the first six months of 2017/18. The position will continue to be monitored on an ongoing basis, but current interest rate forecasts coupled with the corresponding restructuring penalty costs indicate it is unlikely that any debt rescheduling will be undertaken during the remainder of the year.

INVESTMENT ACTIVITY

5.1 INVESTMENTS

a) In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As set out in Section 3, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the 0.25% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis and its impact on banks, prompts a low risk strategy. Given this risk environment and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low.

b) The Council held £11.5m of balances in interest bearing accounts as at 30 September 2017 (£6.1m at 31 March 2017). As a result of current market uncertainties, the Council has been prioritising the security of deposits by investing surplus balances with money market funds and the UK Government's Debt Management Office (DMO).

c) The increase in the level of balances invested from March to September, highlighted above are due to timing differences between additional borrowing undertaken and corresponding capital expenditure, detailed in section 4.4 above.

d) The Council, due to the cashflow position and the requirement to manage the Pension Fund cash as well as the Council's, continues to explore opportunities to invest surplus balances in the short term.

5.2 INVESTMENT COUNTERPARTY CRITERIA

a) The current investment counterparty criterion, approved in the Treasury Management Strategy, represents a prudent approach to risk and the Council's concerns about security of investments. These prudent limits mean there are limited investment options when operating the cash-flow on a short term management basis.

b) Considering security, liquidity and yield of investment, priority is given to security. Daily updates and reports are received from Capita Asset Services that allow officers to assess the continued credit worthiness of investment counter parties. At the end of September, the Council's bank, The Bank of Scotland had it credit rating upgraded one step by Moody's (one of the three main credit ratings agencies). This is a positive step, given the banks short and long term outlook downgrades by all three agencies in July 2016.

c) All investments undertaken are on a short term, highly liquid basis, allowing access to invested funds at 1 days notice.

d) Interest rates are also monitored on a daily basis to ensure the best return is obtained. Target for internal return on cash investment is to be above the 7 Day LIBID rate. The return for six months to 30 September 2017 has averaged 0.16%, compared against an average seven day LIBID rate of 0.11%.

LOAN CHARGES

a) The **Loan Charges** Revenue Budget estimate contained in the Council's Financial Plans approved on 09 February 2017 was £20.185m. It is expected that charges for 2017/18 will be lower than the budgeted figure, in line with the actual and projected borrowing requirements for the year.

ANNEX A

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