

SCOTTISH BORDERS COUNCIL

TREASURY MANAGEMENT MID-YEAR REPORT 2018/19

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 2018/19 as highlighted throughout this report.

2 ECONOMIC POSITION

2.1 ECONOMIC UPDATE *(from Link Asset Services)*

UK. The first half of 2018/19 has seen UK **economic growth** post a modest performance, but sufficiently robust for the Monetary Policy Committee, (MPC), to unanimously (9-0) vote to increase **Bank Rate** on 2nd August from 0.5% to 0.75%. Although growth looks as if it will only be modest at around 1.5% in 2018, the Bank of England’s August Quarterly Inflation Report forecast that growth will pick up to 1.8% in 2019, albeit there were several caveats – mainly related to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.

Some MPC members have expressed concerns about a build-up of **inflationary pressures**, particularly with the pound falling in value again against both the US dollar and the Euro. The Consumer Price Index (CPI) measure of inflation rose unexpectedly from 2.4% in June to 2.7% in August due to increases in volatile components, but is expected to fall back to the 2% inflation target over the next two years given a scenario of minimal increases in Bank Rate. The MPC has indicated Bank Rate would need to be in the region of 1.5% by March 2021 for inflation to stay on track. Financial markets are currently pricing in the next increase in Bank Rate for the second half of 2019.

As for the **labour market**, unemployment has continued at a 43 year low of 4% on the Independent Labour Organisation measure. A combination of job vacancies hitting an all-time high in July, together with negligible growth in total employment numbers, indicates that employers are now having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to 2.9%, (3 month average regular pay, excluding bonuses) and to a one month figure in July of 3.1%. This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings

grew by about 0.4%, near to the joint high of 0.5% since 2009. (The previous high point was in July 2015.) Given the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This tends to confirm that the MPC were right to start on a cautious increase in Bank Rate in August as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy. However, the MPC will need to tread cautiously before increasing Bank Rate again, especially given all the uncertainties around Brexit.

In the **political arena**, there is a risk that the current Conservative minority government may be unable to muster a majority in the Commons over Brexit. However, our central position is that Prime Minister May's government will endure, despite various setbacks, along the route to Brexit in March 2019. If, however, the UK faces a general election in the next 12 months, this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

USA. President Trump's massive easing of fiscal policy is fuelling a (temporary) boost in consumption which has generated an upturn in the rate of strong growth which rose from 2.2%, (annualised rate), in quarter 1 to 4.2% in quarter 2, but also an upturn in inflationary pressures. With inflation moving towards 3%, the Fed increased rates another 0.25% in September to between 2.00% and 2.25%, this being four increases in 2018, and indicated they expected to increase rates four more times by the end of 2019. The dilemma, however, is what to do when the temporary boost to consumption wanes, particularly as the recent imposition of tariffs on a number of countries' exports to the US, (China in particular), could see a switch to US production of some of those goods, but at higher prices. Such a scenario would invariably make any easing of monetary policy harder for the Fed in the second half of 2019.

EUROZONE. Growth was unchanged at 0.4% in quarter 2, but has undershot early forecasts for a stronger economic performance in 2018. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of manufacturing exports e.g. cars. For that reason, although growth is still expected to be in the region of 2% for 2018, the horizon is less clear than it seemed just a short while ago.

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 GDP 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 growth in the UK is probably neutral. The balance of risks to increases in Bank rate and shorter term PWLB rates are broadly dependent on how strong GDP growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively.

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.
- 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, and due to the election in March of a government which has made a lot of anti-austerity noise. This is likely to lead to friction with the EU when setting the target for the fiscal deficit in the national budget. Unsurprisingly, investors have taken a dim view of this and so Italian bond yields have been rising.
- Austria, the Czech Republic and Hungary now form a strongly anti-immigration bloc within the EU while Italy, this year, has also elected a strongly anti-immigration government. In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position as a result of the rise of the anti-immigration AfD party. To compound this, the result of the Swedish general election in September 2018 has left an anti-immigration party potentially holding the balance of power in forming a coalition government. The challenges from these political developments could put considerable pressure on the cohesion of the EU and could spill over into impacting the euro, EU financial policy and financial markets.
- The imposition of trade tariffs by President Trump could negatively impact world growth. President Trump's specific actions against Turkey pose a particular risk to its economy which could, in turn, negatively impact Spanish and French banks which have significant exposures to loans to Turkey.
- Weak capitalisation of some European banks.
- Rising interest rates in the US could negatively impact emerging countries which have borrowed heavily in dollar denominated debt, so causing an investor flight to safe havens e.g. UK gilts.
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

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

- President Trump's fiscal plans to stimulate economic expansion causing a significant increase in inflation in the US and causing further sell offs of government bonds in major western countries.
- 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 QE, 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.
- 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, whether domestically generated or imported, returning to sustained 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.

Link Asset Services Interest Rate View											
	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	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%
3 Month LIBID	0.75%	0.80%	0.80%	0.90%	1.10%	1.10%	1.20%	1.40%	1.50%	1.60%	1.60%
6 Month LIBID	0.85%	0.90%	0.90%	1.00%	1.20%	1.20%	1.30%	1.50%	1.60%	1.70%	1.70%
12 Month LIBID	1.00%	1.00%	1.00%	1.10%	1.30%	1.30%	1.40%	1.60%	1.70%	1.80%	1.80%
5yr PWLB Rate	2.00%	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%
10yr PWLB Rate	2.40%	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%
25yr PWLB Rate	2.80%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%
50yr PWLB Rate	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%

Source: Link Asset Services – October 2018.

- b) The flow of generally positive economic statistics after the end of the quarter ended 30 June meant that it came as no surprise that the MPC came to a decision on 2 August to make the first increase in Bank Rate above 0.5% since the financial crash, to 0.75%. However, the MPC emphasised again, that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary or contractionary), than before the crash; indeed they gave a figure for this of around 2.5% in ten years' time but they declined to give a medium term forecast. Link Asset Services do not think that the MPC will increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. Link Asset Services also feel that the MPC is more likely to wait until August 2019, than May 2019, before the next increase, to be followed by further increases of 0.25% in May and November 2020 to reach 1.5%. However, the cautious pace of even these limited increases is dependent on a reasonably orderly Brexit.

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 2018/19 was approved by Council on 20 February 2018. 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 2018/19

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 2018/19 was approved on 20 February 2018. **Table 2** shows the current budgets for capital expenditure compared to the original estimates used in the Treasury Management Strategy report for 2018/19.

Table 2	2018/19 Original Budget	2018/19 Current Approved Budget ¹	Variance Original to Current Approved
	£m	£m	£m
Assets & Infrastructure	27.4	31.4	4.0
Other Corporate Services	0.6	2.8	2.2
Children & Young People	7.1	13.2	6.1
Culture & Sport	1.8	2.1	0.3
Economic Development	6.4	4.9	(1.5)
Social Care Infrastructure	0.3	0.3	0
Emergency & unplanned scheme	0.3	0.2	(0.1)
Total Capital Expenditure (PI-1)	43.9	54.9	11.0

¹ Executive Committee 20 November 2018

b) The current approved budget for 2018/19 is higher than the original budget due to adverse timing movements from February 2018 to 31 March 2018 in areas of the capital plan and additional grant received. 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 20 November 2018. The key drivers for the 2018/19 changes in Table 2 are:

- Assets & Infrastructure – Waste Management. Total additions to budget amount to £4.5m. Off set by adverse movement in 2018/19 to the Land and Property Infrastructure projects total £1m
- Other Corporate Services budget - increased by £2.2m due the timing movements in the 2017/18 plan in ICT Transformation.
- Children & Young People – increase of £6.1m due to budget movement from 2017/18 and additional funding received for Early Learning and Childcare.
- Economic Development – Additional budget as a timing movement between financial years for Hawick regeneration and Central Borders Business Park.

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 2018/19 capital programme.

Table 3	2018/19 Original Budget £m	2018/19 Current Approved Budget ¹ £m	Variance - Original to Current Approved £m
Capital Expenditure (PI-1)	43.9	54.9	11.0
Other Relevant Expenditure	0.4	0.4	-
Total Expenditure	44.3	55.3	11.0
<i>Financed by:</i>			
Capital receipts	(2.3)	(2.3)	-
Capital from Revenue (CFCR)	-	(0.4)	(0.4)
Developer Contributions	(0.7)	(0.2)	0.5
Govt. General Capital Grant	(14.4)	(14.4)	-
Govt. Specific Capital Grant	(4.0)	(9.7)	(5.7)
Other Grants & Contributions	(3.7)	(5.2)	(1.5)
Replacement Funds	(2.0)	(2.8)	(0.8)
Total Financing	(27.1)	(35.0)	(7.9)
Net Financing Need for the Year	17.2	20.3	3.1

¹ Executive Committee 20 November 2018

- b) The increase in overall financing need is primarily driven by the additional projected capital expenditure as detailed in table 2, above. The impact on net financing need by this increase in expenditure of £11.0m in total, has been negated somewhat by a material increase in Scottish Government Specific Grants of £5.7m, principally relating to the Hawick Regeneration (carried forward from 2017/18) 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 £3.1m.

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 2018. The revaluation of the School estate and the movement in the capital program has resulted a variance of £15.2m in the CFR.

Table 4	2018/19 Original estimate £m	2018/19 Revised estimate £m	Variance £m
CFR * (PI-2)	322.1	306.9	15.2

The CFR for this calculation includes current capital expenditure assumptions to 30 September 2018

ACTUAL EXTERNAL DEBT (PI-5)

- iii) Projected external debt for 2018/19 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) Due to the cashflow of the capital program no additional borrowing has been incurred during 2018/19, however it is anticipated borrowing of £10m will be required during the remainder of the year.

Table 5	2018/19 Original estimate £m	2018/19 Current Approved Budget £m	Variance £m
Borrowing	215.7	208.7	(7.0)
Other long-term liabilities	70.7	68.0	(2.7)-
Total External Debt (PI-5)	286.4	276.7	(9.7)

(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 2018/19 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	2018/19 Original estimate £m	2018/19 Current Approved Budget £m	Variance £m
Gross External Debt	286.4	276.7	(9.7)
CFR *	356.7	328.6	28.1
(Under)/Over Borrowing against CFR (PI-6)	(70.3)	(51.9)	18.4

** 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 2018/19 financial year and compares them with the original estimates shown in the 2018/19 Treasury Management Strategy Report.

Table 7	2018/19 Original estimate £m	2018/19 Revised estimate £m	Variance £m
Gross External Debt (PI-5)	286.4	276.7	9.7
Authorised Limit inc. Long Term Liabilities(PI-8a)	372.6	372.1	0.5
<i>Variance to External Debt Estimate</i>	<i>86.2</i>	<i>95.4</i>	<i>(9.2)</i>
Operational Boundary inc. Long Term Liabilities (PI-7a)	308.2	309.1	0.9
<i>Variance to External Debt Estimate</i>	<i>21.8</i>	<i>32.4</i>	<i>(8.8)</i>

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 0.5% 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 £17.9m of balances in interest bearing accounts as at 30 September 2018 (£7.6m at 31 March 2018). 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 its 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 2018 has averaged 0.49%, compared against an average seven day LIBID rate of 0.43%.

LOAN CHARGES

- a) The **Loan Charges** Revenue Budget estimate contained in the Council's Financial Plans approved on 20 February 2018 was £20.185m. It is expected that charges for 2018/19 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.	2018/19 Original estimate	2018/19 Revised estimate
PRUDENTIAL INDICATORS				
Capital Expenditure Indicator				
PI-1	Capital Expenditure Limits (£m)	5	43.9	54.9
PI-2	Capital Financing Requirement (£m) (CFR)	7	322.1	316.4
Affordability Indicator				
PI-3	Ratio of Financing Costs to Net Revenue (inc PPP repayment costs)	N/A	9.5%	9.0%
PI-4	Incremental (Saving)/ Cost Impact of Capital Investment Decisions on Council	N/A	£0.00	£0.00

	Tax			
External Debt Indicators				
PI-5	External Debt (£m)	8	286.4	276.7
PI-7a	Operational Boundary (inc. Other Long Term Liabilities) (£m)	9	308.2	309.1
PI-7b	Operational Boundary (exc. Other Long Term Liabilities) (£m)	N/A	237.5	241.1
PI-8a	Authorised Limit (inc. Other Long Term Liabilities) (£m)	9	372.7	372.1
PI-8b	Authorised Limit (exc. Other Long Term Liabilities) (£m)	N/A	302.0	304.1
Indicators of Prudence				
PI-6	(Under)/Over Net Borrowing against the CFR (£m)	8	(70.3)	(51.8)
TREASURY INDICATORS				
TI-1	Upper Limit to Fixed Interest Rates based on Net Debt (£m)		308.2	309.1
TI-2	Upper Limit to Variable Interest Rates based on Net Debt (£m)		107.9	108.2
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%