APPENDIX 1

SCOTTISH BORDERS COUNCIL

ANNUAL TREASURY MANAGEMENT REPORT YEAR TO 31 MARCH 2015

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 2014/15. 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 2014/15, the Council's strategy with regard to interest rates and future expectations and how the capital expenditure incurred by the Council in 2014/15 was funded. The investment strategy for 2014/15 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 2014/15, 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	**2014/15 Actual £m**	**2014/15 Estimate * £m**	**Variance £m**
Actual Capital Expenditure *(PI-1)*	**31.4**	**45.8**	**(14.4)**
Total Capital Financing Requirement (CFR) ** *(PI-2)*	**255.0**	**266.1**	**(11.1)**
(Under)/Over Gross Borrowing against the CFR *(PI-6)* ***	**(40.1)**	**(59.0)**	**(18.9)**

** Revised estimate, approved by Council on 20 November 2014 as part of the mid-year report*
*** The CFR for this calculation includes current capital expenditure to 31 March 2014*
**** 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 2014/15 and the statutory borrowing limit (the authorised limit) was not breached.

1.5 The economic environment during the 2014/15 financial year continued to remain challenging, with low investment returns.

2. COUNCIL'S CAPITAL EXPENDITURE AND FINANCING 2014/15

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	**2014/15 Actual £m**	**2014/15 Estimate £m**	**Variance £m**
Place	23.6	29.8	(6.2)
People	2.5	8.9	(6.4)
Chief Executive	5.3	7.1	(1.8)
Total Capital Expenditure *(PI-1)*	**31.4**	**45.8**	**(14.4)**

c) The final capital expenditure for 2014/15 was lower than projected as a result of delays in expenditure on a number of projects, including Hawick flood protection, Galashiels transport interchange, Kelso High School and Duns Primary School. The specific drivers for each of the movements have been disclosed in the regular monitoring reports to the Executive throughout 2014/15 and in the out-turn report presented in 9 June 2015.

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 2014/15 capital expenditure.

Table 3	**2014/15 Actual £m**	**2014/15 Estimate £m**	**Variance £m**
Capital Expenditure	31.4	45.8	(14.4)
Other Relevant Expenditure *	2.1	6.0	(3.9)
Total Expenditure	**33.5**	**51.8**	**(18.3)**
Financed by:			
Capital Grants & Other Contributions	20.6	28.1	(7.5)
SBC Revenue Funding	2.1	2.1	-
Capital Fund/Capital Receipts	0.4	1.2	(0.8)
Plant & Vehicle Fund	1.5	4.0	(2.5)
Total identified finance	**24.6**	**35.4**	**10.8**
Net Financing Need for the Year	**8.9**	**16.4**	**(7.5)**

** This consists of net lending to the National Housing Trust (NHT) during 2014/15 of £0.986m & capitalised landfill provision of £1.16m.*

The decrease in unfinanced capital expenditure compared with the estimate in the mid-year report resulted principally from slippage 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).** 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 2014/15 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 that comparing gross borrowing vs the CFR and by the authorised limit.

d) The extent to which the Council is under/over borrowed at 31 March 2015 is calculated by comparing actual external debt against the CFR and is shown in **Table 4** below. The Council's CFR for the year is shown below and represents a key prudential indicator. It includes PFI and leasing schemes on the balance sheet, which increase the Council's borrowing need. No borrowing is actually required against these schemes, which is why these amounts have been deducted in **Table 4**.

Table 4	**31 March 2015 Actual £m**	**31 March 2015 Estimate £m**	**Variance £m**
CFR *(PI-2)**	**255.0**	**266.1**	**(11.1)**
Less: Other long term liabilities **	56.1	55.9	0.2
Underlying borrowing requirement	**198.9**	**210.2**	**(11.3)**
External Borrowing at 31/3/15	170.6	176.6	(6.0)
(Under)/Over borrowing	**(28.3)**	**(33.6)**	**(5.3)**

* *The CFR for this calculation includes current capital expenditure to 31 March 2015*
** *PPP/PFI/Finance Lease balances*

e) The reason for the increase in the level of under-borrowing, compared to that projected, is that the Council had sufficient positive cash-flow to fund expenditure without borrowing. The decision not to borrow at this point was driven by the following considerations:

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

(ii) 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.

(iii) the extension of the forecasts on low interest rates this meant 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 (2014/15) plus the estimates of any additional capital financing requirement for the current (2015/16) 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 2014/15. 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 2015 Actual £m**	**31 March 2015 Estimate £m**	**Variance £m**
Fixed rate funding			
PWLB	127.6	127.6	-
Market	-	0.2	(0.2)
Variable rate funding			
Market *	43.0	43.0	-
External Borrowing	**170.6**	**170.8**	**(6.0)**
Other long term liabilities **	56.1	55.9	0.2
Total Debt	**226.7**	**226.7**	**-**
CFR (inc. next 2 year estimates)	266.9	282.8	(15.9)
(Under)/Over Gross Borrowing against the CFR *(PI-6)*	**(40.2)**	**(56.1)**	**(15.9)**

* *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 2014/15.

c) There was no rescheduling of debt during 2014/15. 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 2014/15.

Table 6	**31 March 2015 Actual £m**	**Authorised Limit *(PI-8)* £m**	**Variance £m**	**Operational Boundary *(PI-7)* £m**	**Variance £m**
Total Gross Borrowing	**226.8**	**334.5**	**(117.7)**	**232.9**	**(6.1)**

3.3 MATURITY PROFILE OF EXTERNAL DEBT

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

Table 7	**31 March 2015 £m**
Under 12 months	0.1
12 months and within 5 years	-
5 years and within 10 years	13.8
Over 10 years	156.9
Total	**170.8**

4. INTEREST RATE MOVEMENTS AND EXPECTATIONS

4.1 TREASURY STRATEGY FOR 2014/15

a) The expectation for interest rates within the strategy for 2014/15 anticipated low but rising Bank Rate (starting in quarter 1 of 2015), and gradual rises in medium and longer term fixed borrowing rates during 2014/15. 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 actual movement in gilt yields meant that PWLB rates saw little overall change during the first four months of the year but there was then a downward trend for the rest of the year with a partial reversal during February.

c) The comparison of the annual average percentage interest rates to projections within the 2014/15 strategy is set out in **Table 8** below.

Table 8	**Bank Rate**	**PWLB Rates %**		
	%	**5 year**	**25 year**	**50 year**
2014/15 Estimate	0.5	2.7	4.0	4.0
2014/15 Actual	0.5	1.9	3.2	3.1
Variance	**-**	***0.8***	***0.8***	***0.9***

4.2 THE ECONOMY AND INTEREST RATES – 2014/15

a) The original market expectation at the beginning of 2014/15 was for the first increase in Bank Rate to occur in quarter 1 2015 as the unemployment rate had fallen much faster than expected through the Bank of England's initial forward guidance target of 7%. In May, however, the Bank revised its forward guidance. A combination of very weak pay rises and inflation above the rate of pay rises meant that consumer disposable income was still being eroded and in August the Bank halved its forecast for pay inflation in 2014 from 2.5% to 1.25%. Expectations for the first increase in Bank Rate therefore started to recede as growth was still heavily dependent on buoyant consumer demand. During the second half of 2014 financial markets were caught out by a halving of the oil price and the collapse of the peg between the Swiss franc and the euro. Fears also increased considerably that the ECB was going to do too little too late to ward off the threat of deflation and recession in the Eurozone.
In mid-October, financial markets had a major panic for about a week. By the end of 2014, it was clear that inflation in the UK was going to head towards zero in 2015 and possibly even turn negative. In turn, this made it clear that the MPC would have great difficulty in starting to raise Bank Rate in 2015 while inflation was around zero and so market expectations for the first increase receded back to around quarter 3 of 2016.

b) Gilt yields were on a falling trend for much of the last eight months of 2014/15 but were then pulled in different directions by increasing fears after the anti-austerity parties won power in Greece in January; developments since then have increased fears that Greece could be heading for an exit from the euro. While the direct effects of this would be manageable by the EU and ECB, it is very hard to quantify quite what the potential knock on effects would be on other countries in the Eurozone once the so called impossibility of a country leaving the EZ had been disproved. Another downward pressure on gilt yields was the announcement in January that the ECB would start a major programme of quantitative easing, purchasing EZ government and other debt in March. On the other hand, strong growth in the US caused an increase in confidence that the US was well on the way to making a full recovery from the financial crash and would be the first country to start increasing its central rate, probably by the end of 2015. The UK would be closely following it due to strong growth over both 2013 and 2014 and good prospects for a continuation into 2015 and beyond. However, there was also an increase in concerns around political risk from the general election due in May 2015.

c) The Funding for Lending Scheme, announced in July 2012, resulted in a flood of cheap credit being made available to banks which then resulted in money market investment rates falling drastically in the second half of that year and continuing throughout 2014/15.

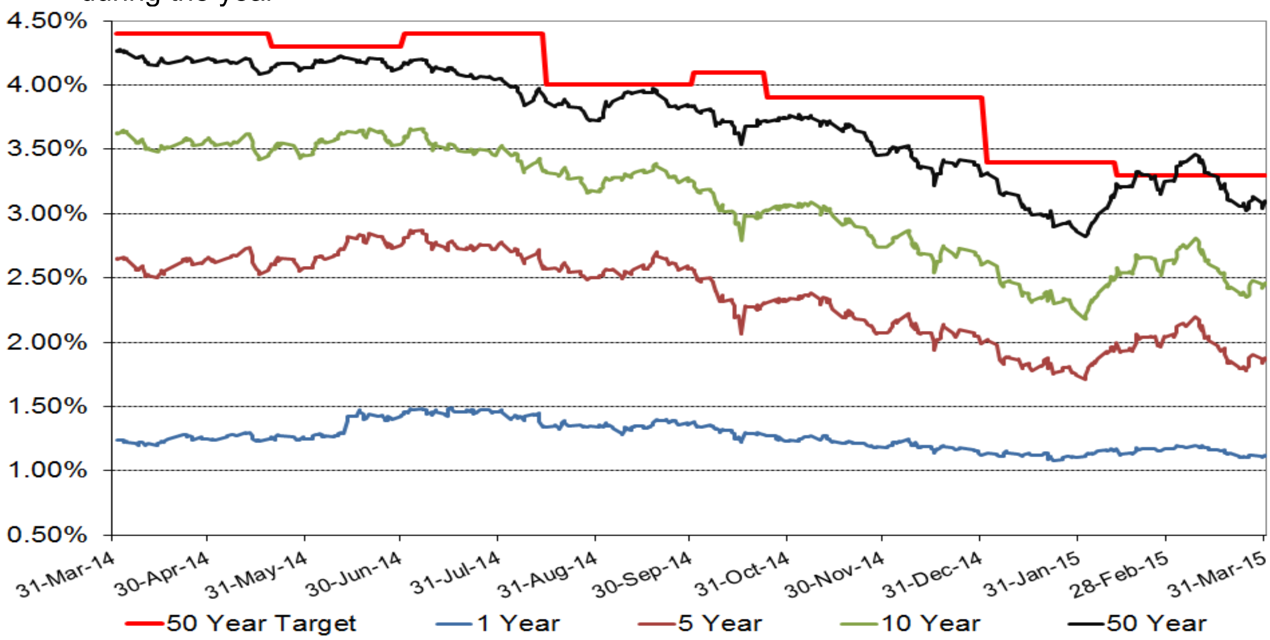
d) The UK coalition Government maintained its tight fiscal policy stance but recent strong economic growth and falling gilt yields led to a reduction in the forecasts for total borrowing in the March budget.

e) The EU sovereign debt crisis had subsided since 2012 until the Greek election in January 2015 sparked a resurgence of fears. While the UK and its banking system has little direct exposure to Greece, it is much more difficult to quantify quite what effects there would be if contagion from a Greek exit from the euro were to severely impact other major countries in the EZ and cause major damage to their banks.

4.3 BORROWING RATES IN 2014/15

a) **PWLB Borrowing Rates**

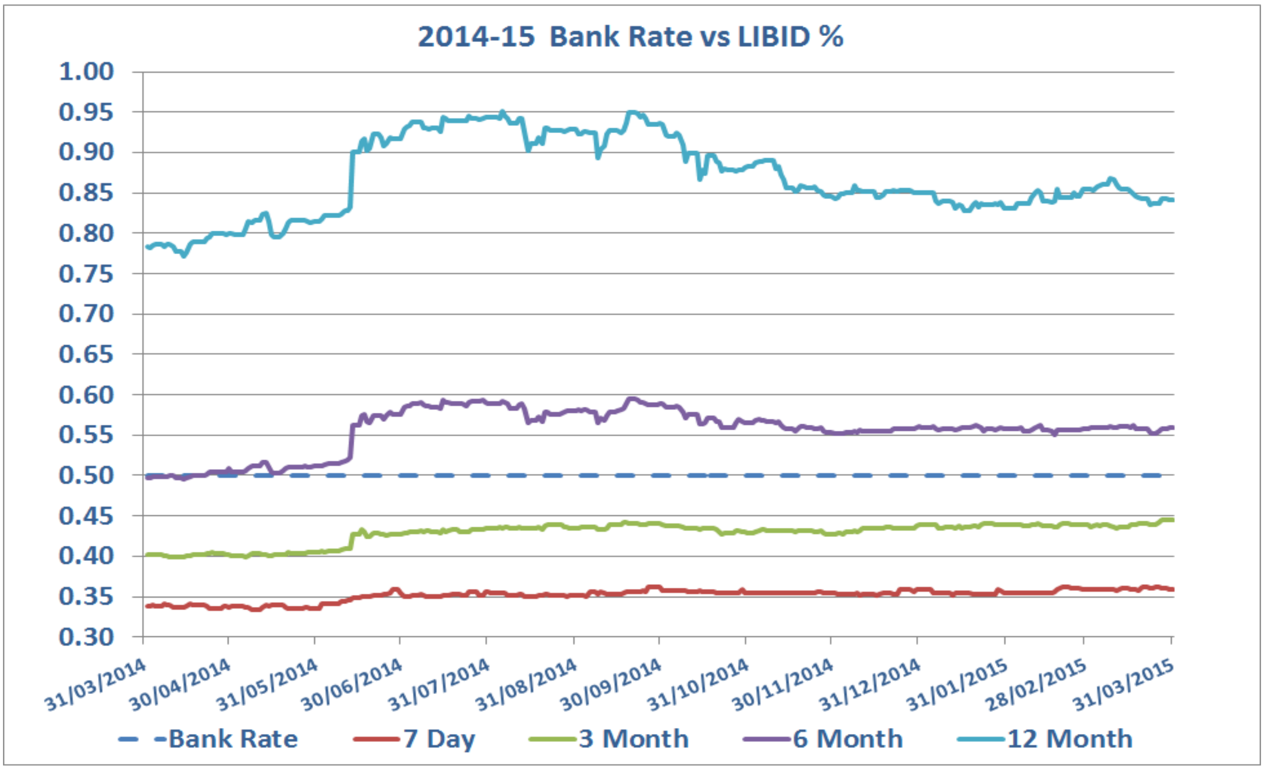
Chart 1 below illustrates how PLWB certainty rates have fallen to historically very low levels during the year



4.4 INVESTMENT RATES IN 2014/15

Bank Rate remained at its historic low of 0.5% throughout the year; it has now remained unchanged for six years. Market expectations as to the timing of the start of monetary tightening started the year at quarter 1 2015 but then moved back to around quarter 3 2016 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.

Chart 2 below illustrates the change in the Investment Rates certainty maturity rates, for a selection of maturity periods, throughout 2014/15.



5. INVESTMENT OUTTURN FOR 2014/15

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 2015 was £11.6m. Cash was held on a short term basis throughout 2014/15 with major banks and various money market funds (the latter having a credit rating of AAA).

5.4 ICELANDIC BANK DEPOSIT DEFAULTS

a) **Heritable Bank**
The Council received no returns relating to claims on Heritable Bank in 2014/15 and currently retains 94.8% of its original deposit.

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 2014/15.

The Council's loans fund pool rate for 2014/15 was 4.65%. The Scottish Local Authority average "pool rate" for 2014/15 is not yet available at the time of writing, but was 4.44% in 2013/14 and is not expected to be materially different for 2014/15.

b) **Average rate movement year on year**. Target is to maintain or reduce the average borrowing rate for the Council versus 2013/14. The Council's pool rate of 4.65% for 2014/15 **was 0.30% higher** than the reported Council's rate of 2013/14. This variation can mainly be attributed to a refinement in the calculation process.

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 when compared to the whole portfolio.

(ii) The actual performance of this indicator was 0.017% **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 0.0004%, 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 2014/15, money was deposited in accounts on a short term basis, not exceeding 3 months.

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 2014/15.

(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 2014/15 was 0.0048 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 2014/15 averaged 0.37%, compared against an average 7 day LIBID rate for the year to 31 March 2014 of 0.35%, so was better than target for the year. Yields remain low though as 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).

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 2014/15 mid year report to the outturn as at 31 March 2015 is as follows:

Table 9	**Actual**	**Estimate**
Ratio of financing costs to net revenue stream *(PI-3)*	**% 8.93**	**% 9.40**

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.

Table 10	**2014/15 Actual £m**	**2014/15 Estimate £m**	**Variance (Under) /Over £m**
Interest on Borrowing	11.8	11.3	0.5
Investment Income	(0.1)	(0.1)	-
Capital Repayments	6.1	9.6	(3.5)
Total Loan Charges	**17.8**	**20.8**	**(3.0)**

(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). The actual interest on borrowing figure was lower than estimated as borrowing undertaken during the year was lower than anticipated.

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 2014/15.

Table 11	**2014/15 Revised Indicator**		**2014/15 Actual as at 31 March 2015**
Upper limits – Debt with fixed and variable interest rates			
Upper limits on fixed interest rates *(TI-1)*	258.3		230.7
Upper limits on variable interest rates *(TI-2)*	90.4		80.7
Maturity Structure of borrowing			
	Upper *(TI-3)*	**Lower** *(TI-4)*	**Actual**
Under 12 months	20%	0%	0.09%
12 months to 2 years	20%	0%	0.00%
2 years to 5 years	20%	0%	0.00%
5 years to 10 years	20%	0%	7.85%
10 years and above	100%	20%	92.06%
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.	2014/15 Original estimate	2014/15 Revised estimate	2014/15 Actual
PRUDENTIAL INDICATORS					
Capital Expenditure Indicator					
PI-1	Capital Expenditure	3	£42.28m	£45.8m	£31.4m
PI-2	Capital Financing Requirement (CFR)	6	£282.6m	£266.1m	£255.0m
Affordability Indicator					
PI-3	Ratio of Financing Costs to Net Revenue	16	10.4%	9.4%	8.93%
PI-4	Incremental Impact of Capital Investment Decisions on Council Tax	N/A	0.01	0.03	0.04
External Debt Indicators					
PI-5	Actual Debt	8	£266.6m	£232.6m	£226.8m
PI-7a	Operational Boundary (inc. Other Long Term Liabilities)	9	£279.8m	£258.3m	£232.9m
PI-7b	Operational Boundary (exc. Other Long Term Liabilities)	9	£223.7m	£194.1m	£176.7m
PI-8a	Authorised Limit (inc. Other Long Term Liabilities)	9	£340.6m	£308.1m	£334.5m
PI-8b	Authorised Limit (exc. Other Long Term Liabilities)	9	£284.5m	£252.1m	£278.4m
Indicators of Prudence					
PI-6	(Under)/Over Gross Borrowing against the CFR	8	(£28.2m)	(£59.0m)	(£40.1m)
TREASURY INDICATORS					
TI-1	Upper Limit to Fixed Interest Rates based on Net Debt	16	£279.8m	£258.3m	£230.7m
TI-2	Upper Limit to Variable Interest Rates based on Net Debt	16	£97.9m	£90.4m	£80.7m
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%