The Highland Council

Resources Committee - 26 August 2015

Agenda Item	18(b)
Report No	RES/ 74/15

Annual Treasury Management Report – 2014/15

Report by Director of Finance

Summary

The attached Annual Treasury Management Report for 2014/15 is prepared in compliance with the Chartered Institute of Public Finance and Accountancy's (CIPFA) revised Code of Practice on Treasury Management in Local Authorities. The revised Code was adopted by the Council on 3 March 2010.

The report highlights the Council's treasury management activities undertaken, provides a commentary on the year, and compares activity to the expected activities contained in the annual Treasury Strategy Statement and Investment Statement which was approved by the Council on 13 March 2014.

In compliance with the Code, the attached Annual Treasury Management Report - 2014/15 is submitted to the Committee for consideration. The Report will then be submitted to Council for approval in September 2015.

In addition, the Prudential Code requires the Council to report the actual prudential indicators after the financial year end and these are contained in this report.

1. Background

1.1 In December 2001, CIPFA published a Revised Code of Practice on Treasury Management (the Code) with a suggested implementation date of 1 April 2002. The Council adopted the revised Code in February 2002 and fully complies with its requirements.

1.2 The primary requirements of the Code are the:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by the Council of an Annual Strategy Report for the year ahead, a mid–year report and an **Annual Review Report** of the previous year.
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
- Delegation by the Council of the role of scrutiny of treasury management policies to a specific named body, which in this Council is the Resources Committee.

1.3 Treasury Management is defined as: "*The management of the local authority's 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*".

1.4 This report sets out:

- An overview of the Strategy agreed for 2014/15 considering the economy and interest rates position for the year (section 2)
- Performance measurement for the year (section 3)
- The Council's treasury position at 31 March 2015 compared to the previous financial year (section 3)
- A summary of treasury decisions taken and effects on the revenue budget (section 4)
- A commentary on performance and risk (section 5)
- A review of compliance with the Council's procedures and Prudential Indicators (section 6 and section 7)

2. The Strategy Agreed for 2014/15

2.1 The expectation for interest rates within the strategy for 2014/15 anticipated low but rising Bank Base Rates (starting in quarter 2 of 2016), 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.

2.2 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.

2.3 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.

2.4 Further information on the economy and interest rates during the year can be found at **Appendix 1**.

3. Performance measurement

3.1 Whilst investment performance criteria have been well developed, the traditional average portfolio rate of interest remains the principal debt performance indicator (as incorporated in the Table at Section 3.2 below).

3.2 The treasury position at the 31 March 2015 compared with the previous year is detailed in the table below.

	31 March 2015		31 March 2014		Year on Year	
	Balance £m	**Avg. Rate (%)**	**Balance £m**	**Avg. Rate (%)**	**Balance £m**	**Avg. Rate (%)**
Debt						
Fixed Interest Rate						
Long term debt	645.1	4.88	600.9	5.00	-44.2	-0.12
Short term debt	15.0	0.48	41.1	0.48	-26.1	-
Variable Interest Rate	101.0	5.01	101.0	5.01	-	-
Total Debt	**761.1**	**4.81**	**743.0**	**4.75**	**-70.3**	-0.12
Investments						
Fixed Interest Rate	22.0	0.61	24.9	0.69	-2.9	-0.08
Variable Interest Rate	43.3	0.48	52.0	0.50	-8.7	-0.02
Total Investments	**65.3**	**0.52**	**76.9**	**0.56**	**-11.6**	**-0.04**
Debt net of investments	**695.8**		**666.1**			

3.3 The figures highlight a marginal increase in the average interest rate on external debt borrowings from 4.75% at March 2014 to 4.81% at March 2015. This was due to the Council replacing a 6 year loan that matured on 31 March 2015 (3.24%) with longer term borrowing at marginally higher rates. The investment return for 2014/15 was slightly down on the previous year due to marginally lower interest rates being paid on deposits.

3.4 The total debt amount of £761.1m comprises the borrowing raised and repaid in the table below. Temporary loans had an average rate of 0.48% at 31 March 2015. The details of all long term borrowing undertaken and repaid, is in **Appendix 3.**

	31 March 2014 £m	**Borrowing raised £m**	**Borrowing repaid £m**	**31 March 2015 £m**
PWLB	584.0	54.1	10.0	628.1
Mortgage bonds	118.0	-	-	118.0
Temporary loans	41.1	66.7	92.8	15.0
Totals	743.1	120.8	102.8	761.1

4. Treasury decisions taken and revenue effects

Borrowing

4.1 The actual net capital expenditure compared to the net capital expenditure in the Treasury Strategy 2014/15 is below. Reasons for variations in Service and project capital expenditure for the year are reported to Strategic Committees as part of the final 2014/15 out-turn capital monitoring reports. Details of gross capital for the year, against the estimated position, are in **Appendix 2**.

Net capital expenditure	Per Treasury Strategy 2014/15 £m	Per mid- year report 2014/15 £m	Actual 2014/15 £m	Variance £m
General Fund	53.8	70.8	50.0	-20.8
HRA	52.9	35.4	27.0	-8.4
Total	**106.7**	**106.2**	**77.0**	**-29.2**
Instalments*	(35.2)	(35.2)	(35.2)	-
	71.5	71.0	41.8	-29.2

*Instalments are the amount by which the debt outstanding is written off each year. The amount depends on the period of write off for the loan. The loan charge instalment is calculated using an annuity factor.

4.2 After accounting for capital grant income, the estimated borrowing requirement (net of instalments) to fund net capital expenditure per the Treasury Management mid-year report for 2014/15 was £71.0m and the actual was £41.8m.

4.3 The reason for the variance in General Fund net capital expenditure, was due to capital programme slippage.

4.4 During 2014/15, a total of £54.1m was borrowed from the PWLB. The average rate of this borrowing was 3.38% and average repayment term was 18.7 years, taking the opportunity to access attractive borrowing rates for this maturity period, while at the same time aiming to balance the maturity profile of the overall debt portfolio. Of the £54.1m, £4.1m was borrowed for on-lending as part of the National Housing Trust programme for which the Council has specific borrowing consents and guarantees from the Scottish Government. The details of all long term borrowing undertaken and repaid, during 2014/15 is in **Appendix 3**.

4.5 The remaining £50.0m of the PWLB borrowing was undertaken to finance net capital expenditure in the year (£41.8m) and replace £10m debt maturing in the year.

4.6 The remainder of the funding for the year came from short-term borrowing and use of internal balances.

4.7 In November 2012, the PWLB introduced a certainty rate, whereby if local authorities applied for the certainty rate scheme and gave HM Treasury forward borrowing plans, they would be guaranteed a reduced PWLB rate (0.2% discount). The Council benefitted from the discounted rate on new borrowings from that date onwards.

Rescheduling

4.8 There was no rescheduling completed during 2014/15. While refinancing rates were closely monitored throughout the year no significant opportunities arose to make savings due to breakage costs.

4.9 A summary of Outstanding Deferred Revenue Costs attributable to debt rescheduling exercises undertaken in years to date, is provided in the table below. These represent early debt repayment costs (premiums) and discounts, associated with debt rescheduling. It is accounting practice for these to be written off over the periods of the new loans taken as part of the rescheduling. The approach being that these costs are spread over the same period the saving from the new lower rate loans will be realised.

	Outstanding 31 March 2014 **£000**	**Incurred 2014/15** **£000**	**Written off 2014/15** **£000**	**Outstanding 31 March 2015** **£000**
Premiums	37,503	-	(1,992)	35,511
Discounts	(7,041)	-	40	(7,001)
Net Deferred Revenue Costs	30,462	-	(1,952)	28,510

4.10 The Council's calculated loans fund interest rate for the year was 4.88% against a budgeted rate of 4.94%, the budget having been calculated on the assumption that there would be an upwards trend in borrowing rates, which did not materialise during the year and that borrowing would be undertaken earlier in the year.

4.11 Revenue effect: The final position shows a budget saving of £2.5m (General Fund) and £0.6m (HRA) in loan charges compared to budget for the year. This is partly a result of the Council having been able to take advantage of sustained and historically low long term borrowing rates and favourable cash flow.

Investments held by the Council

4.12 The Council's investment policy is governed by the Scottish Government Investment Regulations, which were adopted in the Annual Investment Strategy 2010/11 and approved by the Council on 24 June 2010. This policy sets out the approach for choosing investment categories and counterparties, and is 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.).

4.13 The Council's policy states the maximum investment period is 2 years. However during 2014/15 deposits were placed for periods of less than 1 year to reflect credit risk.

4.14 The Council maintained an average end of month balance of £88.8m of internally managed funds. These internally managed funds earned an average rate of return of 0.54%. The comparable performance indicator is the average 7-day LIBID rate, and this was 0.48%.

4.15 No institutions in which investments were made showed any difficulty in repaying the investment and interest in full during the year.

5. Performance and risk

5.1 The Council's debt portfolio has been proactively managed over the year and Officers have continued to take advantage of the relatively low interest rates on offer to favourably position the debt portfolio against potential adverse interest rate movements.

5.2 As a consequence, there is limited risk of volatility of costs in the current debt portfolio as the interest rates are predominantly at attractive, fixed long-term levels (£645.1m of long term fixed debt representing 86% of the total gross debt portfolio).

5.3 All major borrowing and CFR financing decisions taken by officers were undertaken following discussion with the Council's treasury management advisors. Current indications are that assumptions made on future long term interest rate movements are still in line with subsequent market movements, and it is now expected that the trend in low long term rates over all periods will continue for some time.

5.4 Returns on the Council's investments are predominantly determined by short-term variable rates. Whilst this can introduce an element of volatility to returns, it is minimal in terms of the total debt portfolio. Risk, in relation to the potential loss of principal, is minimised through the Council's restricted lending list (using a diversified list of counter-parties and based on credit risk assessment).

5.5 The Council uses three firms of money market brokers to facilitate short-term borrowing and investment deals. This ensures competitive market rates are obtained. All brokers charged the same level of commission per transaction and performed satisfactorily. In addition, the Council's treasury management staff has direct lines to some major banks to facilitate investment business.

6. Compliance with the Council's procedures and Prudential Indicators

6.1 The Council has complied with its internal procedures and the requirements of the CIPFA Code of Practice on Treasury Management. The Council is bound by best practice requirements, which involve limits to be set and adhered to in relation to short-term borrowing and exposure to variable interest rates.

6.2 The following tables detail the Council's limits that apply to these requirements and it should be noted that the Council complied with these limits throughout the year.

Maximum the Council may have outstanding by way of short term borrowing (net of investments)

	Maximum during 2014/15	**Position at 31/03/15**
Short term borrowing (net of investments) as a % of outstanding long term debt	(3.48%)*	(8.79%)*
Council limit	**25.00%**	**25.00%**

* Short term investments exceeded short term borrowing in these instances, shown in (brackets) above.

Total amount of exposure to variable interest rates (net of investments)

	Maximum During 2014/15	**Position At 31/03/15**
Variable interest debt (net of investments) as a % of outstanding long term debt	9.08%	8.26%
Council limit	**35.00%**	**35.00%**

7. The Prudential Code – Indicators

7.1 The Council is required by the Prudential Code to report the actual prudential indicators compared with actual treasury positions at the year-end. **Appendix 2** provides details of all the mandatory, estimated and actual prudential indicators for the year 2014/15.

7.2 Capital Financial Requirement

The capital financing requirement (CFR) represents the accumulated net capital expenditure which the Council requires to fund by way of long term borrowing and other capital financing, until the capital projects, comprising the CFR, are fully written off to revenue (mainly by way of annual loan charges).

7.3 In recent years the Council has been in a position whereby its CFR is greater than its long-term borrowing. This results from the Council using internal cash sources, as well as long-term borrowing to finance the CFR. The use of internal cash sources can represent a more effective and low cost option for financing, compared to long-term borrowing, given the low returns available on short-term deposits when compared to PWLB rates, even in the current low borrowing rate environment.

7.4 However, the Council must keep the CFR and long-term borrowing position under regular review, as the use of internal cash sources can result in increased re-financing risk i.e. if internal cash sources are utilised, and the Council has no choice but to borrow, and not necessarily at a time of its choosing, borrowing costs could be impacted.

7.5 The CFR is kept under regular review, and in recent years part of the annual treasury strategy has been to take steps to manage the CFR versus long-term borrowing position to an acceptable level. Paragraph 4.4 describes the net additional long-term PWLB borrowing undertaken in the year. As shown in the table below the difference between CFR and long-term borrowing stood at £24.9m as at 31/03/15. This position will be kept under regular review as part of on-going treasury management arrangements.

7.6 In order to ensure that over the medium term borrowing net of investments will only be for a capital purpose, net borrowing should not, except in the short term, exceed the CFR for 2014/15. The table below highlights that the Council has complied with this requirement.

	31/03/15
CFR excl PPP	£786.0m
External borrowing position	£761.1m
CFR not yet funded by long-term borrowing	£24.9m

Borrowing Limits

7.7 The Council is required to agree an Authorised Limit for borrowing for the year. This figure provides for estimated contingencies which may require to be funded in the year in addition to planned capital expenditure. The table below demonstrates that during 2014/15 the Council maintained its gross borrowing within its Authorised Limit.

	2014/15
Indicator - Authorised Limit for borrowing	£916.5m
Indicator - Operational Boundary for borrowing	£854.5m
Maximum borrowing position during the year	£772.3m
Minimum borrowing position during the year	£719.6m

7.8 The Operational Boundary, also approved by the Council in compliance with the Code, is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the Boundary are acceptable subject to the Authorised Limit not being breached.

8. Implications

8.1 Resource; Legal; Equalities; Climate Change/Carbon Clever; Risk; Gaelic and Rural implications relating to this report. – there are no specific implications to highlight, as the report represents a retrospective review of 2014/15 treasury management performance.

9. Recommendation

Members are asked to consider the report and agree the Annual Treasury Report 2014/15 is submitted to the Council for approval.

Designation: Director of Finance

Date: 17 August 2015

Author: Catriona Stachan, Accountant

Background Papers:

Logotech Treasury Management System reports

Capita Treasury reports

Treasury Strategy Statement and Investment Strategy 2014/15

This Treasury Management Report is a document impacting on the whole of the Highland population and therefore all aspects of equalities have to be cross referenced against all duties which apply. This Treasury Management Report has been screened for its impact on equalities groups and does not require a full equalities impact assessment.

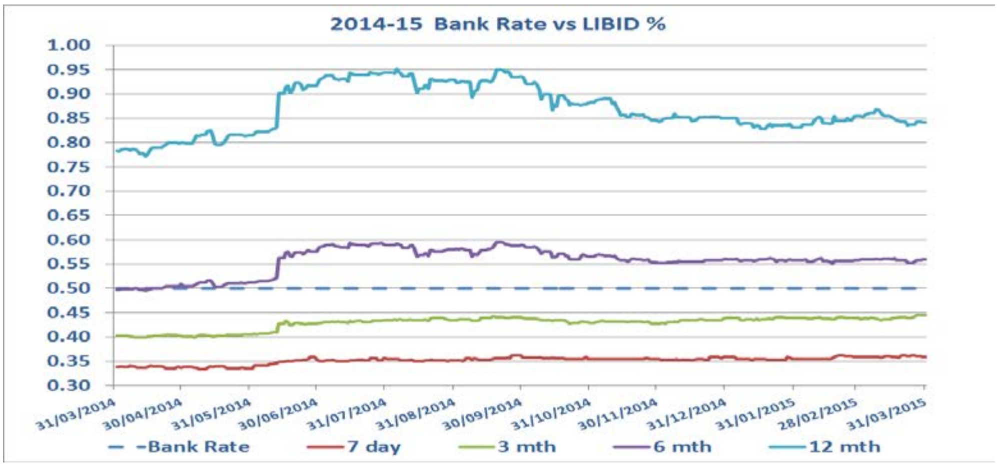
Appendix 1

The economy and interest rates during the year

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.

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.



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.

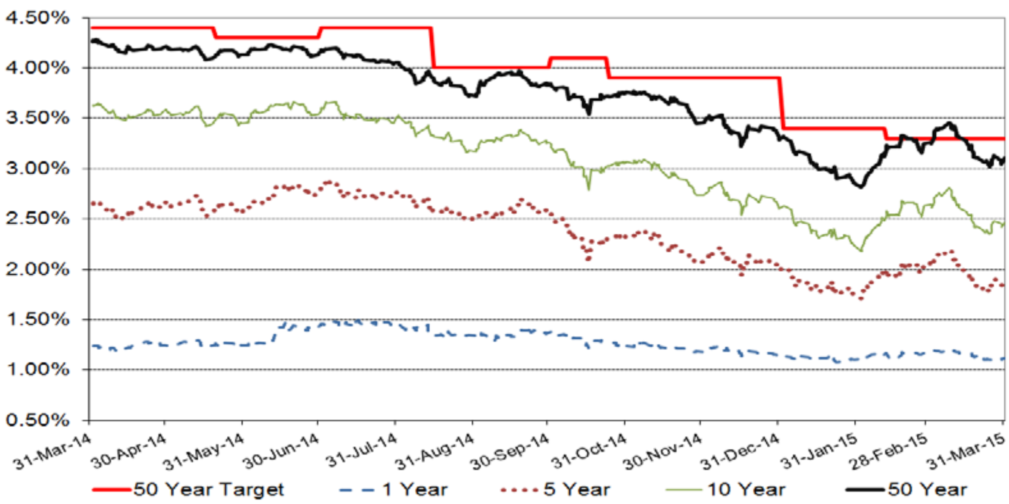
Another downward pressure on gilt yields was the announcement in January that the ECB would start a major programme of quantitative easing, purchasing EZ government and other debt in March. On the other hand, strong growth in the US caused an increase in confidence that the US was well on the way to 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.

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.

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.

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.

PWLB borrowing rates - the graphs and table for PWLB certainty maturity rates below show for a selection of maturity periods, the high and low points in rates, the average rates, spreads and individual rates at the start and the end of the financial year.



Appendix 2

Estimated and Actual Treasury Position and Prudential Indicators

Figures are for financial year unless otherwise titled in italics		2014/15 Indicator (revised Nov 2014)	2014/15 Actual
1	**Capital expenditure**		
	Gross capital expenditure		
	General Fund including PPP	£132.5m	£107.9m
	Housing Revenue Account	£51.5m	£43.3m
	Total gross capital expenditure	**£184.0m**	**£151.2m**
	Income		
	General Fund	(£61.7m)	(£57.9m)
	HRA	(£16.1m)	(£16.3m)
	Total income	**(£77.8m)**	**(£74.2m)**
	Net capital expenditure		
	General Fund	£70.8m	£50.0m
	HRA	£35.4m	£27.0m
	Total net capital expenditure	**£106.2m**	**£77.0m**
	Instalments		
	General Fund	(£28.2m)	(£28.2m)
	HRA	(£7.0m)	(£7.0m)
	Total instalments	**(£35.2m)**	**(£35.2m)**
	Net borrowing for new capital expenditure		
	General Fund	£42.6m	£21.8m
	HRA	£28.4m	£20.0m
	Total net borrowing for new capital expenditure	**£71.0m**	**£41.8m**
2	**Capital Financing Requirement (CFR) at 31 March**		
	General Fund excluding PPP	£570.3m	£557.6m
	Housing Revenue Account	£213.2m	£205.2m
	Joint Boards	£23.2m	£23.2m
	Sub total excluding PPP	£806.7m	£786.0m
	PPP	£125.9m	£125.9m
	Total	**£932.6m**	**£911.9m**
	General Fund including PPP	£696.2m	£683.5m
3	**Treasury Position at 31 March**		
	Borrowing	£773.0m	£761.1m
	Other Long Term Liabilities	£125.9m	£125.9m
	Total Debt	£898.9m	£887.0m
	Investments	£50.0m	£65.3m
	Net Borrowing	**£848.9m**	**£821.7m**
4	**Authorised Limit for Borrowing** (against maximum position)	£916.5m	£772.3m

5	**Operational Boundary for Borrowing**	£854.5m	£772.3m
6	**Ratio of financing costs to net revenue stream**		
	General Fund including PPP	12.1%	12.4%
	Housing Revenue Account	30.4%	34.5%
7	**Incremental impact of capital investment** decisions on the Band D council tax	£18.43	£12.41
8	**Incremental impact of capital investment** decisions on the housing rent levels (Weekly figures based on a 48 week year are shown in brackets). There is zero incremental impact on Council Tax and Rents shown as Council Tax and Housing Rents have already been already set for these years.	£60.68 (£1.26)	£48.94 (£1.02)
9	**Interest rate exposures of debt net of investments**		
	Upper Limit (Fixed)	£825.5m	£638.1m
	Upper Limit (Variable)	£288.9m	£61.8m
10	**Maturity structure of fixed rate borrowing (against maximum position**)		
	Under 12 months	30%	8.3%
	12 months to 2 years	30%	3.4%
	2 years to 5 years	30%	11.8%
	5 years to 10 years	50%	12.1%
	10years and above	100%	69.5%
11	**Upper limit for the maturing of investments made for periods longer than 364 days(against maximum position**)	£10m	£nil

In addition to the above the Council is required as a Prudential Indicator to:

- Adopt the CIPFA Code of Practice.
- Ensure that over the medium term borrowing will only be for a capital purpose (i.e. net external borrowing is less than the CFR).

The compliance for these indicators is highlighted in the body of the report.

Appendix 3 – Borrowing undertaken and borrowing repaid 2014/15

Borrowing undertaken during 2014/15

Month	Amount	Purpose of borrowing	Duration	Rate
September 2014	£20m	Capital programme	50 years	3.95%
February 2015	£20m	Capital programme	48 years	2.84%
March 2015	£10m	Capital programme	20 years	3.30%
Total	**£50m**			

June 2014	£0.87m	NHT Kiltarlity	6 years	3.15%
July 2014	£0.43m	NHT Kiltarlity	6 years	3.02%
Sept 2014	£0.92m	NHT – Ardersier	6 years	2.89%
March 2015	£0.6m	NHT – Balvonie	6 years	2.31%
March 2015	£1.3m	NHT – Westercraigs	7 years	2.09%
Total	**£4.12m**			

Total borrowing **£54.12m**

Borrowing repaid during 2014/15

Month repaid	Amount	Purpose of borrowing	Duration	Rate
March 2015	£10m	Capital programme	6 years	3.24%