The Highland Council

Resources Committee - 24 August 2016

Agenda Item	**13(b)**
Report No	**RES/ 49/16**

Annual Treasury Management Report – 2015/16

Report by Director of Finance

Summary

The attached Annual Treasury Management Report for 2015/16 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 12 March 2015.

In compliance with the Code, the attached Annual Treasury Management Report - 2015/16 is submitted to the Committee for consideration. The Report will then be submitted to Council for approval in September 2016.

In addition, the Prudential Code requires the Council to report the actual prudential indicators after the financial year end and these are shown in **Appendix 2**.

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 2015/16 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 2016 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 (sections 6 and 7)

2. The Strategy Agreed for 2015/16

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

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.

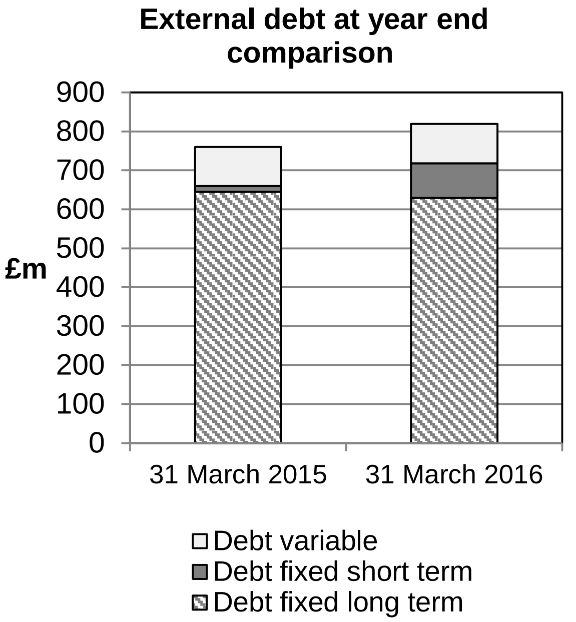
2.3 The sharp volatility in equity markets during the year was reflected in sharp volatility in bond yields. However, the overall dominant trend in bond yields since July 2015 has been for yields to fall to historically low levels as forecasts for inflation have repeatedly been revised downwards and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

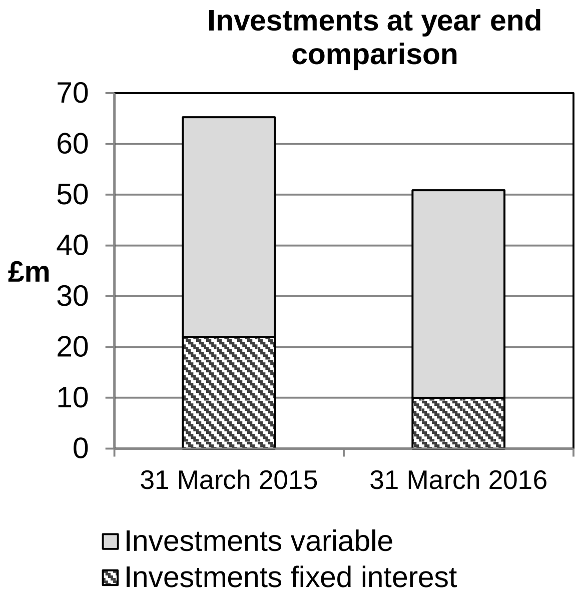
2.4 Further information on the economy and interest rates during the year can be found at **Appendix 1**.

3. Performance measurement

3.1 Whilst investment performance criteria have been well developed, the traditional average portfolio interest rate remains the principal debt performance indicator (see table in section 3.2 below).

3.2 The treasury position at the 31 March 2016 compared with the previous year is detailed in the graphs below.





Average interest rates comparison	**31/03/2015**	**31/03/2016**
External debt long term	4.88%	4.91%
External debt short term	0.48%	0.51%
External debt variable	5.01%	4.96%
Total debt	**4.81%**	**4.44%**
Investments fixed interest	0.61%	0.93%
Investments variable	0.48%	0.55%
Total investments	**0.52%**	**0.62%**

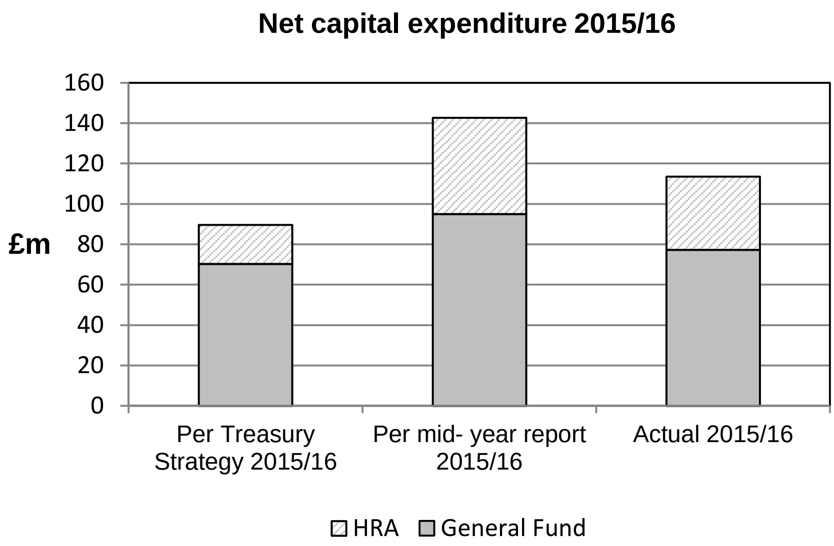
3.3 The figures show an overall decrease in the average interest rate on external debt borrowings from 4.81% at March 2015 to 4.44% at March 2016. This was due to the Council using short term borrowing to fund capital expenditure for which lower rates are paid. The investment return for 2015/16 was higher than the previous year due to deposits being placed longer term to cover future cash flows.

3.4 The total debt amount of £818.4m and the details of all long term borrowing undertaken and repaid, is in **Appendix 3.** Temporary loans had an average rate of 0.51% at 31 March 2016.

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 2015/16 is below. Reasons for variations in Service and project capital expenditure for the year are reported to Strategic Committees as part of the final 2015/16 out-turn capital monitoring reports. Details of gross capital spend for the year, against the estimated position, are in **Appendix 2**.



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 2015/16 was £107.1m and the actual was £78.1m (**see Appendix 1, indicator 1**). The reason for the variance in General Fund net capital expenditure, was due to capital programme slippage.

4.3 During 2015/16, no long term borrowing was undertaken from the PWLB for capital expenditure which was funded by short term borrowing. There was £5m borrowed from the PWLB 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 the long term borrowing undertaken for on-lending to the National Housing Trust programme are in **Appendix 3**. The average rate of this borrowing was 2.38% and average repayment term was 6.4 years.

Rescheduling

4.4 There was no rescheduling completed during 2015/16. While refinancing rates were closely monitored throughout the year no significant opportunities arose to make savings due to breakage costs.

4.5 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 Mar 2015 £000	Incurred 2015/16 £000	Written off 2015/16 £000	Outstanding 31 Mar 2016 £000
Premiums	35,511	-	(1,992)	33,519
Discounts	(7,001)	-	40	(6,961)
Net Deferred Revenue Costs	28,510	-	(1,952)	26,558

Overall performance

4.6 The Council's calculated loans fund interest rate for the year was 4.52% against a budgeted rate of 4.84%, the budget having been calculated on the assumption that long term borrowing would be undertaken. As stated above, capital expenditure was funded using short term borrowing.

4.7 Revenue effect: The final position shows a budget saving of £1.7m (General Fund) and £0.4m (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 short term borrowing rates and partly as a result of reduced capital spend.

Investments held by the Council

4.8 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.).

4.9 The Council's policy states the maximum investment period is 2 years. However during 2015/16 deposits were placed for periods of 1 year or less than 1 year to reflect credit risk.

4.10 The Council maintained an average end of month balance of £76.6m of internally managed funds which earned an average rate of return of 0.62%. The comparable performance indicator is the average 7-day LIBID rate, and this was 0.49%. 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 (£629m of long term fixed debt representing 77% 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 have direct lines to some major banks to facilitate direct investment with suitably rated institutions.

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 table details 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 during 2015/16	**Position as at 31/03/16**
Short term borrowing (net of investments) as a % of outstanding long term debt	5.19%	5.19%
Council limit	**25.00%**	**25.00%**
Variable interest debt (net of investments) as a % of outstanding long term debt	7.70%	7.70%
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 2015/16.

7.2 Capital Financing 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).

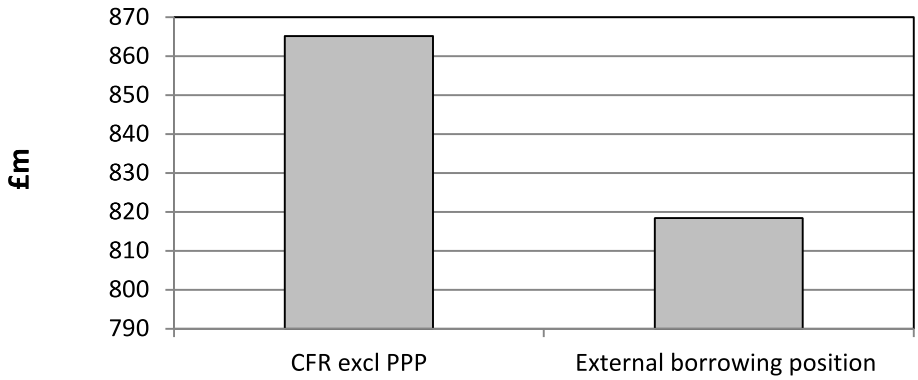
7.3 In recent years the Council has been in a position whereby its CFR is greater than its long-term borrowing. This results from the Council using internal cash sources, as well as long-term borrowing to finance the CFR. The use of internal cash sources can represent a more effective and low cost option for financing, compared to long-term borrowing, given the low returns available on short-term deposits when compared to Public Works Loans Board (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 4.1** 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 £63.4m as at 31/03/16. 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 2015/16. The graph below shows that the Council has complied with this requirement.

Borrowing position compared to CFR as at 31 March 2016

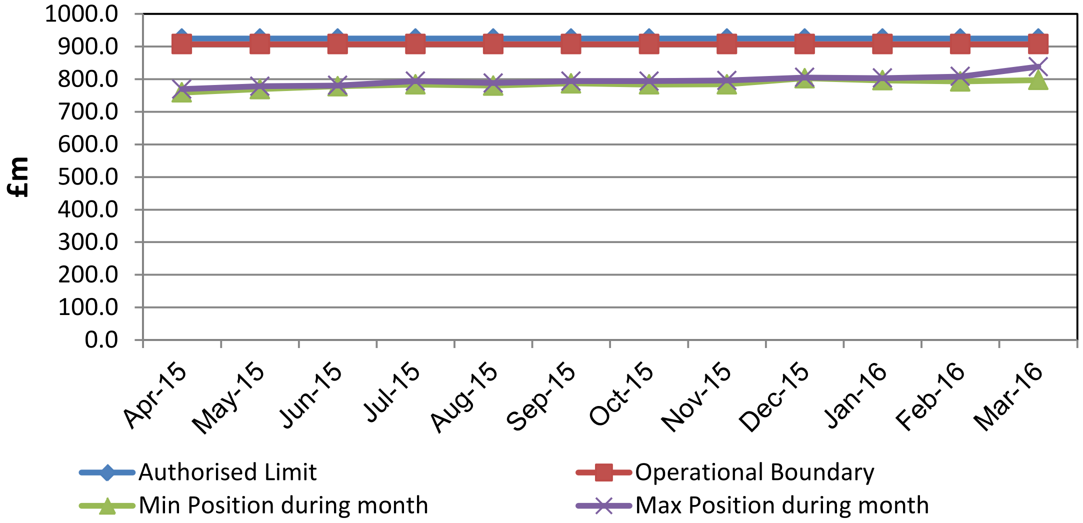


Borrowing Limits

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 graph below demonstrates that during 2015/16 the Council maintained its gross borrowing within its Authorised Limit.

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.

Minimum and maximum external borrowing compared to limits



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 2015/16 treasury management performance.

9. Recommendation

Members are asked to consider the report and agree the Annual Treasury Report 2015/16 is submitted to the Council for approval.

Designation: Director of Finance

Date: 12 August 2016

Author: Catriona Stachan, Accountant

Background Papers:

Logotech Treasury Management System reports

Capita Treasury reports

Treasury Strategy Statement and Investment Strategy 2015/16

Appendix 1

The economy and interest rates during the year

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

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

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

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

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

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

Appendix 2

Estimated and Actual Treasury Position and Prudential Indicators

Figures are for financial year unless otherwise titled in italics		2015/16 Indicator	2015/16 Actual
1	**Capital expenditure**		
	Gross capital expenditure		
	General Fund including PPP	£136.9m	£117.4m
	Housing Revenue Account	£65.0m	£55.8m
	Total gross capital expenditure	**£201.9m**	**£173.2m**
	Income		
	General Fund	(£41.9m)	(£40.1m)
	HRA	(£17.3m)	(£19.4m)
	Total income	**(£59.2m)**	**(£59.5m)**
	Net capital expenditure		
	General Fund	£95.0m	£77.3m
	HRA	£47.7m	£36.4m
	Total net capital expenditure	**£142.7m**	**£113.7m**
	Loan charge instalments		
	General Fund	(£28.2m)	(£28.2m)
	HRA	(£7.4m)	(£7.4m)
	Total instalments	**(£35.6m)**	**(£35.6m)**
	Net borrowing for new capital expenditure		
	General Fund	£66.8m	£49.1m
	HRA	£40.3m	£29.0m
	Total net borrowing for new capital expenditure	**£107.1m**	**£78.1m**
2	**Capital Financing Requirement (CFR) at 31 March**		
	General Fund excluding PPP	£624.5m	£608.8.m
	Housing Revenue Account	£245.5m	£234.1m
	Joint Boards	£22.2m	£22.2m
	Sub total excluding PPP	£892.2m	£865.1m
	PPP	£122.0m	£122.0m
	Total	**£1,014.2m**	**£987.1m**
	General Fund including PPP	£746.5m	£730.8m
3	**Treasury Position at 31 March**		
	Borrowing	£856.0m	£818.4m
	Other Long Term Liabilities (PPP)	£122.0m	£122.0m
	Total Debt	**£978.0m**	**£940.4m**
	Investments	£50.0m	£50.9m
	Net Borrowing	**£928.0m**	**£889.5m**

Figures are for financial year unless otherwise titled in italics		2015/16 Indicator	2015/16 Actual
4	**Authorised Limit for Borrowing** (against maximum position)	£924.3m	£838.2m
5	**Operational Boundary for Borrowing**	£907.1m	£838.2m
6	**Ratio of financing costs to net revenue stream**		
	General Fund including PPP	12.2%	11.9%
	Housing Revenue Account	35.0%	33.9%
7	**Incremental impact of capital investment** decisions on the Band D council tax	£27.66	£0.66
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.	£79.20 (£1.65)	£58.57 (£1.22)
9	**Interest rate exposures of debt net of investments**		
	Upper Limit (Fixed)	£865.1m	£708.4m
	Upper Limit (Variable)	£302.8m	£59.0m
10	**Maturity structure of fixed rate borrowing (against maximum position**)		
	Under 12 months	30%	15.3%
	12 months to 2 years	30%	3.1%
	2 years to 5 years	30%	12.6%
	5 years to 10 years	50%	10.4%
	10 years and above	100%	70.4%
11	**Upper limit for the maturing of investments made for periods longer than 364 days(against maximum position**)	£10m	£5m

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 – PWLB Borrowing undertaken and borrowing repaid 2015/16

PWLB Borrowing undertaken during 2015/16

May 2015	£1.30m	NHT -Westercraigs	6 years	2.36%
July 2015	£0.93m	NHT -Westercraigs	6 years	2.46%
August 2015	£0.70m	NHT -Westercraigs	6 years	2.47%
September 2015	£0.75m	NHT -Westercraigs	6 years	2.36%
December 2015	£1.35m	NHT – Academy Street	6 years	2.31%
Total	**£5.03m**			

PWLB Borrowing repaid during 2015/16

Month repaid	Amount	Purpose of borrowing	Duration	Rate
March 2016	£20.7m	Capital programme	6 years	3.3%