ARGYLL AND BUTE COUNCIL	**COUNCIL**
STRATEGIC FINANCE	**30 JUNE 2016**

ANNUAL TREASURY REPORT 2015-16

1. EXECUTIVE SUMMARY

1.1 This report outlines the Council's Treasury Management position for 2015-16.

1.2 The Council is required by regulations issued under the Local Government in Scotland Act 2003 to produce an annual review of treasury management activities and the actual prudential and treasury indicators and submit this to Council. The report at Appendix 1 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).

1.3 The key points to note from the annual report are:

- Savings in interest of £1.1m have been achieved through postponing borrowing.
- Reporting requirements under the Code were met during 2015-16.
- Borrowing reduced from £173m to £158m during the year with an average rate of 5.5%. The Council was able to access a project loan of £9.5m from the Public Works Loans Board (PWLB) at 2.96%. Repayments were made of £10.6m of long term loans and £13.9m of temporary borrowing.
- The Capital Financing Requirement (excluding NPDO commitments) was £178m leading to under borrowing of £20m (up from £6m).
- Investments at 31 March 2016 were £46m at an average rate of 0.782% compared to £56m at an average rate of 0.644% for 31 March 2014.
- The average investment rate for 2015-16 was 0.685% compared to the average 7 day rate of 0.363% generating an additional return of £0.2m

1.4 This report meets the Code requirement for a treasury annual report. The Council remains under borrowed (around 11% of the CFR is not supported by borrowing) but current borrowing and investment rates mean additional costs would be incurred to address this. The Council was able to access a Project Rate Loan from the PWLB at a rate of 2.96% and whilst investment rates are low we exceeded our benchmark.

2. RECOMMENDATIONS

2.1 The Treasury Management Annual Report is approved.

3. IMPLICATIONS

3.1 Policy – None

3.2 Legal – None

3.3 Human Resources – None

3.4 Financial – None

3.5 Equal Opportunities – None

3.6 Risk – None

3.7 Customer Service – None

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Appendix 1 – Annual Treasury Report 2015-16

Appendix 1

ANNUAL TREASURY REPORT

2015-2016

1. Introduction

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 2015/16. 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).

During 2015/16 the minimum reporting requirements were that the full Council or the Policy and Resources Committee should receive the following reports:

- an annual treasury strategy in advance of the year (Council 12 February 2015)
- a mid-year (minimum) treasury update report (Policy and Resources Committee 17 December 2015)
- an annual review following the end of the year describing the activity compared to the strategy (this report).

In addition, the Policy and Resources Committee has received treasury management update reports on 20 August 2015, 29 October 2015, 11 February 2016 and 17 March 2016.

The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

This Council also confirms that it has complied with the requirement under the Code to give scrutiny to all of the above treasury management reports by the Performance Review and Scrutiny Committee.

2. The Economy and Interest Rates

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 European Central Bank (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.

3. Overall Treasury Position as at 31 March 2016

At the beginning and the end of 2015/16 the Council's treasury (excluding borrowing by PFI and finance leases) position was as follows:

	31 March 2015 Principal	Rate/ Return	Average Life yrs	31 March 2016 Principal	Rate/ Return	Average Life yrs
Total debt	***£173m***	***5.4%***	***29.18***	***£158m***	***5.5%***	***30.97***
CFR	***£180m***			***£178m***		
Over / (under) borrowing	***(£6m)***			***(£20m)***		
Total investments	***£56m***	***0.6%***		***£46m***	***0.8%***	
Net debt	**£117m**			**£112m**		

4. The Strategy for 2015/16

The expectation for interest rates within the treasury management strategy for 2015/16 anticipated low but rising Bank Rate, (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.

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.

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.

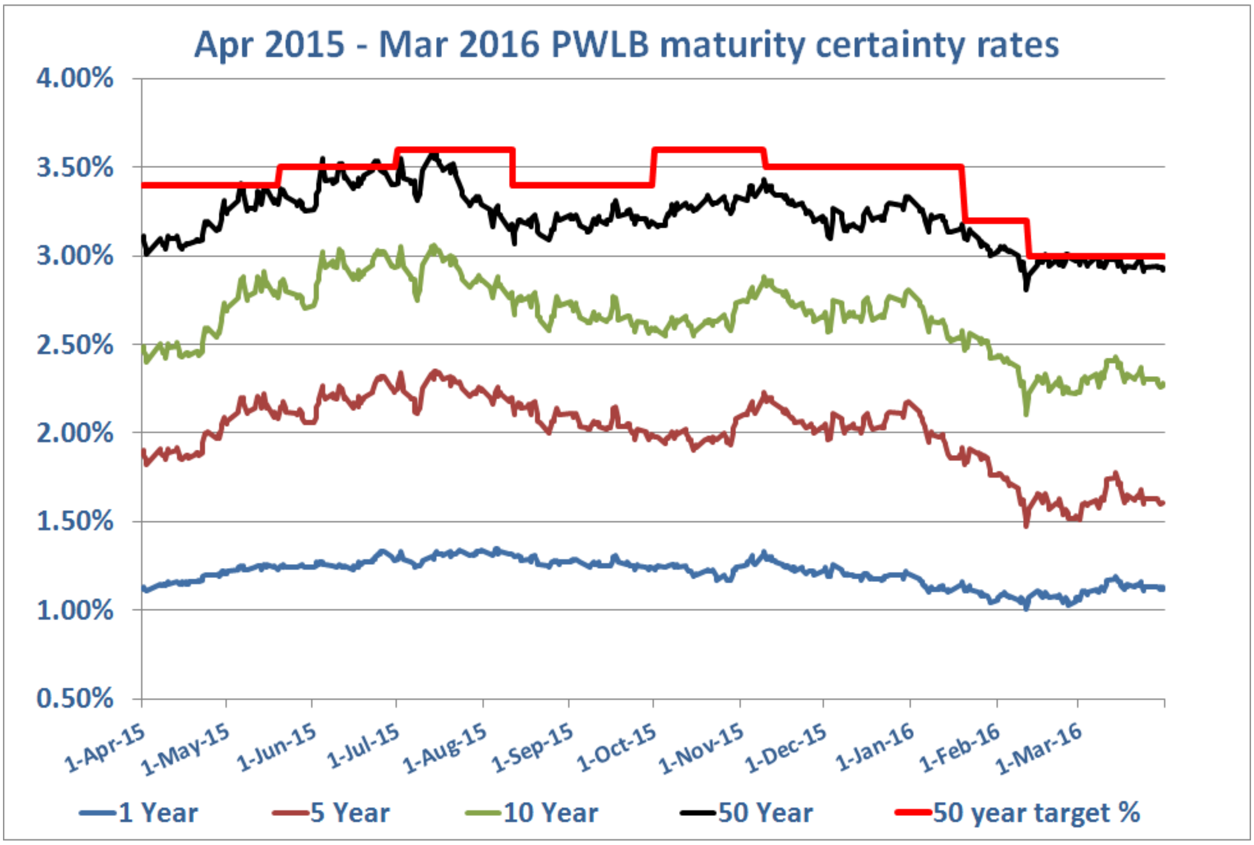
5. The Borrowing Requirement

The Council's underlying need to borrow to finance capital expenditure is termed the Capital Financing Requirement (CFR).

	31 March 2015 Actual	31 March 2016 Budget	31 March 2016 Actual
CFR (£m)	258	273	254
Less NPDO	78	78	76
Net CFR	180	195	178

6. Borrowing Rates in 2015/16

Public Works Loans Board (PWLB) certainty maturity borrowing rates - the graph below shows how PWLB certainty rates have fallen to historically very low levels during the year.



7. Borrowing Outturn for 2015/16

Borrowing – the following loans were taken during the year: -

Lender	Principal	Type	Interest Rate	Maturity
PWLB	£9.5m	Fixed interest rate	2.96%	50 years
East Renfrewshire Council	£2.0m	Fixed interest rate	0.50%	2 Months
West Mercia Police Authority	£5.0m	Fixed interest rate	0.45%	7 Weeks

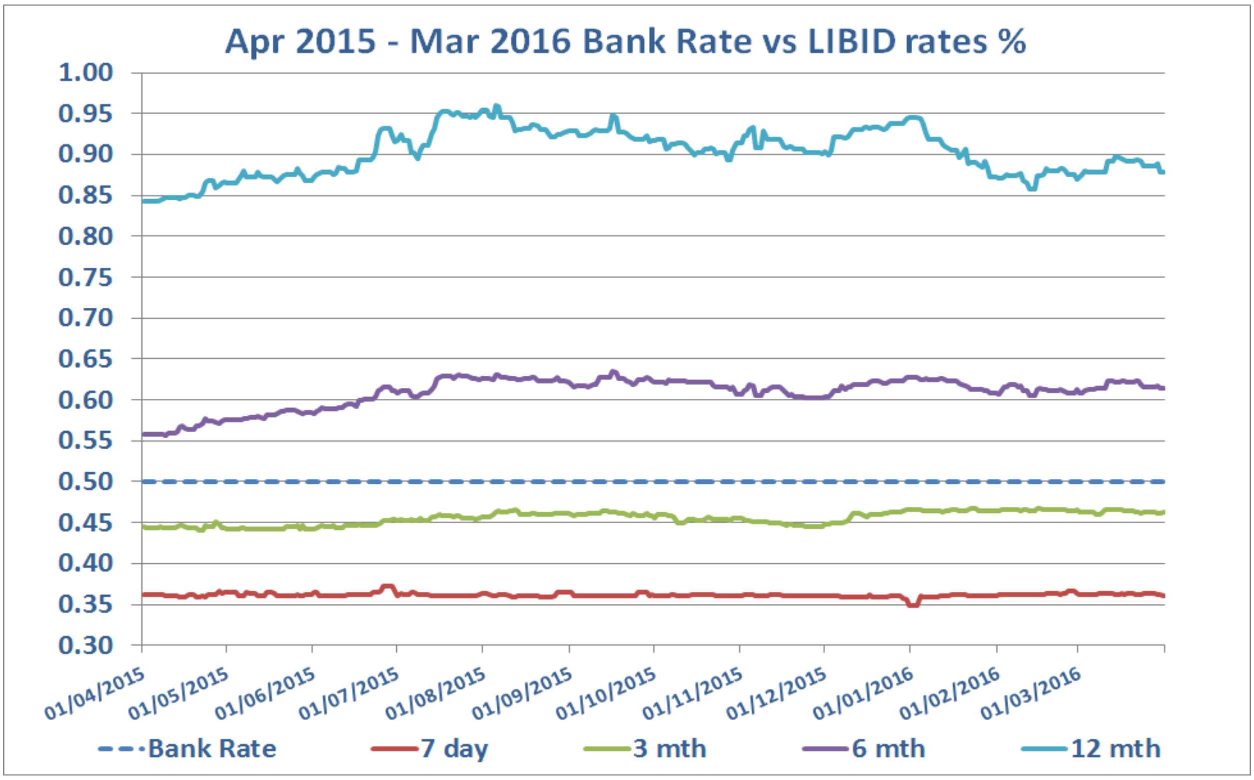
Rescheduling
No rescheduling was carried out during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

Repayments
The Council repaid the following loans during the year using investment balances.

Lender	Principal	Type	Interest Rate
Prudential Assurance	£1.0m	Fixed interest rate	11.375%
PWLB	£2.4m	Fixed interest rate	9.375%
PWLB	£0.4m	Fixed interest rate	9.125%
PWLB	£3.3m	Fixed interest rate	10.000%
PWLB	£0.1m	Fixed interest rate	11.625%
PWLB	£0.4m	Fixed interest rate	11.000%
PWLB	£3.0m	Fixed interest rate	3.280%
Greater Manchester Combined Authority	£10.0m	Fixed interest rate	0.35%
Surrey County Council	£10.0m	Fixed interest rate	0.30%
Other Temporary Borrowing	£1.7m	Fixed interest rate	0.30%

Summary of debt transactions
Management of the debt portfolio resulted in an increase in the average interest rate of 0.1% due to a reduction in temporary borrowing, overall the reduction in interest payments resulted in net General Fund savings of around £1.1m.

8. Investment Rates in 2015/16



Bank Rate remained at its historic low of 0.5% throughout the year; it has now remained unchanged for seven years. Market expectations as to the timing of the start of monetary tightening started the year at quarter 1 2016 but then moved back to around quarter 2 2018 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 and due to the continuing weak expectations as to when Bank Rate would start rising.

9. Investment Outturn for 2015/16

Investment Policy – the Council's investment policy is governed by Scottish Government investment regulations which have been implemented in the annual investment strategy approved by the Council on 12 February 2015. This policy sets out the approach for choosing investment 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.).

The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

Investments held by the Council - the Council maintained an average daily balance of £59.8m of internally managed funds. The internally managed funds earned an average rate of return of 0.685%. The comparable performance indicator is the average 7-day LIBID rate, which was 0.363%. This generated additional interest income of £0.2m

Prudential and Treasury Indicators

During 2015/16, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

Actual prudential and treasury indicators	2014/15 Actual £000	2015/16 Original £000	2015/16 Actual £000
Capital expenditure	36,281	45,505	24,185
Capital Financing Requirement	257,556	272,746	253,896
Gross borrowing	247,280	250,710	233,986
External debt	173,378	158,090	158,089
Investments	56,408	20,000	46,438
Net borrowing	116,970	138,090	111,651

Gross borrowing and the CFR - 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 (2015/16) plus the estimates of any additional capital financing requirement for the current (2016/17) 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 2015/16.

	2015/16
Authorised limit	£286m
Maximum gross borrowing position	£251m
Operational boundary	£278m
Average gross borrowing position	£236m
Financing costs as a proportion of net revenue stream	7.7%

The authorised limit – this Council has kept within its authorised external borrowing limit as shown by the table above.

The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached.

Actual financing costs as a proportion of net revenue stream - 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 stream.

The maturity structure of the debt portfolio was as follows:

	31 March 2015 actual	2015/16 original limits	31 March 2016 actual
Under 12 months	£31.9m	£47.4m	£16.6m
12 months and within 24 months	£18.4m	£47.4m	£8.9m
24 months and within 5 years	£16.4m	£47.4m	£16.4m
5 years and within 10 years	£6.5m	£63.2m	£6.5m
10 years and within 20 years	£0.0m	£126.4m	£0.0m
20 years and within 30 years	£12.9m	£126.4m	£12.9m
30 years and within 40 years	£15.3m	£126.4m	£28.9m
40 years and within 50 years	£30.0m	£126.4m	£36.8m
50 years plus	£42.0m	£126.4m	£31.0m
Total	£173.4m		£158.0m

All investments were for under one year.

The exposure to fixed and variable rates was as follows which demonstrates that the year end position was within the agreed limits:

	31 March 2015 Actual £000	2015/16 Original Limits £000	31 March 2016 Actual £000
Fixed rate (principal or interest) based on net debt	95%	195%	100%
Variable rate (principal or interest) based on net debt	35%	60%	42%