ARGYLL AND BUTE COUNCIL	COUNCIL
STRATEGIC FINANCE	27 JUNE 2019

Annual Treasury Report 2018-19

1. EXECUTIVE SUMMARY

1.1 This report outlines the Council's Treasury Management position for 2018-19.

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:

- Reporting requirements under the Code were met during 2018-19.
- During 2018-19 the Council's External Borrowing Increased by £5m from £178.5m at 31 March 2018 to £183.5m at 31 March 2019. The increase was due to temporary year-end borrowing of £7.7m. This was offset by repayments of £2.7m to the PWLB.
- The Capital Financing Requirement (excluding NPDO and Hub School commitments) was £180.246m this is £3.230m lower that the Council's external debt. This difference is due to unexpected slippage in the Council's capital plan at the year end and a delay in repayment of £2.936m due to 31 March falling over a weekend. The over borrowing will correct itself once the expenditure which slipped is incurred during 2019-20.
- Investments at 31 March 2019 were £75m at an average rate of 0.950% compared to £70m at an average rate of 0.670% for 31 March 2018.
- The average investment rate for 2018-19 was 0.846% compared to the average 7 day LIBID rate of 0.507%. The investments generated £0.732m of interest in 2018-19.
- The Asset Management Fund was invested in Qatar National Bank to increase the rate of return while future long term investment of the fund is being assessed. The return on the fund was £21,600, a rate of return of 1.08%. A number of options for use of the fund are being considered and reports will be brought forward in respect of those that are considered to be potential investments.

1.4 This report meets the Code requirement for a treasury annual report. The Council is over borrowed at 31 March 2019.

1.5 Management of the debt portfolio resulted in a decrease in the average interest rate of 0.23% due to a decrease in long term borrowing, overall the reduction in interest payments resulted in a net General Fund saving of £0.6m.

1.6 The economic and interest rate commentary are provided by the Council's Treasury Advisors, Link Asset Services to assist in the consideration of the Council's treasury performance.

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

Kirsty Flanagan, Head of Strategic Finance
Gary Mulvaney Policy Lead for Strategic Finance

For further information please contact Moira Miller, Principal Accountant – Customer Services 01546-604175

Appendix 1 – Annual Treasury Report 2018-19

Appendix 1

ANNUAL TREASURY REPORT

2018-2019

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 2018-19. 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 2018-19 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: 22 February 2018)
- a mid-year (minimum) treasury update report (Policy and Resources Committee: 13 December 2018)
- 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 16 August 2018, 18 October 2018 and 14 February 2019.

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 Policy and Resources Committee.

2. The Economy and Interest Rates

The following commentary was provided by our treasury advisors, Link Asset Services:

UK. After weak economic growth of only 0.2% in quarter one of 2018, growth picked up to 0.4% in quarter 2 and to a particularly strong 0.7% in quarter 3, before cooling off to 0.2% in the final quarter. Given all the uncertainties over Brexit, this weak growth in the final quarter was as to be expected. However, some recovery in the rate of growth is expected going forward. The annual growth in Q4 came in at 1.4% y/y confirming that the UK was the third fastest growing country in the G7 in quarter 4.

After the Monetary Policy Committee raised the Bank Rate from 0.5% to 0.75% in August 2018, it is little surprise that they have abstained from any further increases since then. We are unlikely to see any further action from the MPC until the uncertainties over Brexit clear. If there were a disorderly exit, it is likely that Bank Rate would be cut to support growth. Nevertheless, the MPC has been having increasing concerns over the trend in wage inflation which peaked at a new post financial crisis high of 3.5%, (excluding bonuses), in the three months to December before falling only marginally to 3.4% in the three months to January. British employers ramped up their hiring at the fastest pace in more than three years in the three months to January as the country's labour market defied the broader weakness in the overall economy as Brexit approached. The number of people in work surged by 222,000, helping to push down the unemployment rate to 3.9 percent, its lowest rate since 1975. Correspondingly, the total level of vacancies has risen to new highs.

As for CPI inflation itself, this has been on a falling trend since peaking at 3.1% in November 2017, reaching a new low of 1.8% in January 2019 before rising marginally to 1.9% in February. However, in the February 2019 Bank of England Inflation Report, the latest forecast for inflation over both the two and three year time horizons remained marginally above the MPC's target of 2%.

The rise in wage inflation and fall in CPI inflation is good news for consumers as their spending power is improving in this scenario as the difference between the two figures is now around 1.5%, i.e. a real terms increase. 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.

Brexit. The Conservative minority government failed to get its Brexit deal through Parliament by the April 12 deadline. The EU has provided a "flextension" to the end of October, but allowing the UK to leave before then if a deal is agreed. Theresa May is standing down as Prime Minister and a Conservative Party leadership contest is underway. The lack of clarity over Brexit, speculation about Mrs May's successor and the prospect of a Brexiteer Prime Minister putting a "no deal" Brexit back on the table, allied to trade uncertainty, is a toxic mix which is unsettling markets, resulting in volatility of interest rate expectations. There is no expectation by the markets of an interest rate rise (or cut) this year given the continuing uncertainty around Brexit.

USA. President Trump's massive easing of fiscal policy in 2018 fuelled a (temporary) boost in consumption in 2018 which generated an upturn in the strong rate of growth; this rose from 2.2%, (annualised rate) in quarter 1 of 2018 to 4.2% in quarter 2, 3.5% in quarter 3 and then back to 2.2% in quarter 4. The annual rate came in at 2.9% for 2018, just below President Trump's aim for 3% growth. The strong growth in employment numbers has fed through to an upturn in wage inflation which hit 3.4% in February, a decade high point. However, CPI inflation overall fell to 1.5% in February, a two and a half year low, and looks to be likely to stay around that number in 2019 i.e. below the Fed's target of 2%. The Fed increased rates another 0.25% in December to between 2.25% and 2.50%, this being the fourth increase in 2018 and the ninth in the upward swing cycle. However, the Fed now appears to be edging towards a change of direction and admitting there may be a need to switch to taking action to cut rates over the next two years. Financial markets are now predicting two cuts of 25 bps by the end of 2020.

EUROZONE. The European Central Bank (ECB) provided massive monetary stimulus in 2016 and 2017 to encourage growth in the EZ and that produced strong annual growth in 2017 of 2.3%. However, since then the ECB has been reducing its monetary stimulus measures and growth has been weakening - to 0.4% in quarters 1 and 2 of 2018, and then slowed further to 0.2% in quarters 3 and 4; it is likely to be only 0.1 - 0.2% in quarter 1 of 2019. The annual rate of growth for 2018 was 1.8% but is expected to fall to possibly around half that rate in 2019. The ECB completely ended its programme of quantitative easing purchases of debt in December 2018, which means that the central banks in the US, UK and EU have all ended the phase of post financial crisis expansion of liquidity supporting world financial markets by purchases of debt. However, the downturn in growth, together with inflation falling well under the upper limit of its target range of 0 to 2%, (but it aims to keep it near to 2%), prompted the ECB to take new measures to stimulate growth. With its refinancing rate already at 0.0% and the deposit rate at -0.4%, it has probably reached the limit of cutting rates. At its March 2019 meeting it said that it expects to leave interest rates at their present levels “at least through the end of 2019”, but that is of little help to boosting growth in the near term. Consequently, it also announced a third round of TLTROs; this provides banks with cheap borrowing every three months from September 2019 until March 2021 which means that, although they will have only a two-year maturity, the Bank is making funds available until 2023, two years later than under its previous policy. As with the last round, the new TLTROs will include an incentive to encourage bank lending, and they will be capped at 30% of a bank’s eligible loans.

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.

WORLD GROWTH. Equity markets are currently concerned about the synchronised general weakening of growth in the major economies of the world: they fear there could even be a recession looming up in the US, though this fear is probably overdone.

3. Overall Treasury Position as at 31 March 2019

At the beginning and the end of 2018-19 the Council's treasury (excluding borrowing by PFI and finance leases) position was as follows:

	31 March 2018 Principal £m	Rate/ Return	Average Life yrs	31 March 2019 Principal £m	Rate/ Return	Average Life yrs
Total debt	***178***	***4.68%***	***35.1***	***183***	***4.45%***	***24.7***
CFR	***177***			***180***		
Over / (under) borrowing	***1***			***3***		
Total investments	***70***	***0.70%***		***75***	***0.95%***	
Net debt	**108**			**108**		

The Council was over borrowed by £3.230m at the 31 March 2019, the budgeted position for 2018-19 predicted a year end under borrowed position of £6.247m. The difference of £9.477m is due in part to slippage of expenditure in the capital programme during 2018-19 and also the repayment of £2.936m of loans due for repayment on 31 March but actually paid on 1 April due to 31 March falling on a non-working day.

4. The Strategy for 2018-19

The expectation for interest rates within the treasury management strategy for 2018-19 anticipated that Bank Rate would stay flat at 0.5% until quarter 4 2018 and not rise above 1.25% by quarter 1 2021. At present there is little expectation, given the on-going Brexit uncertainty that interest rates will rise during 2019.

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.

5. The Borrowing Requirement and Debt

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

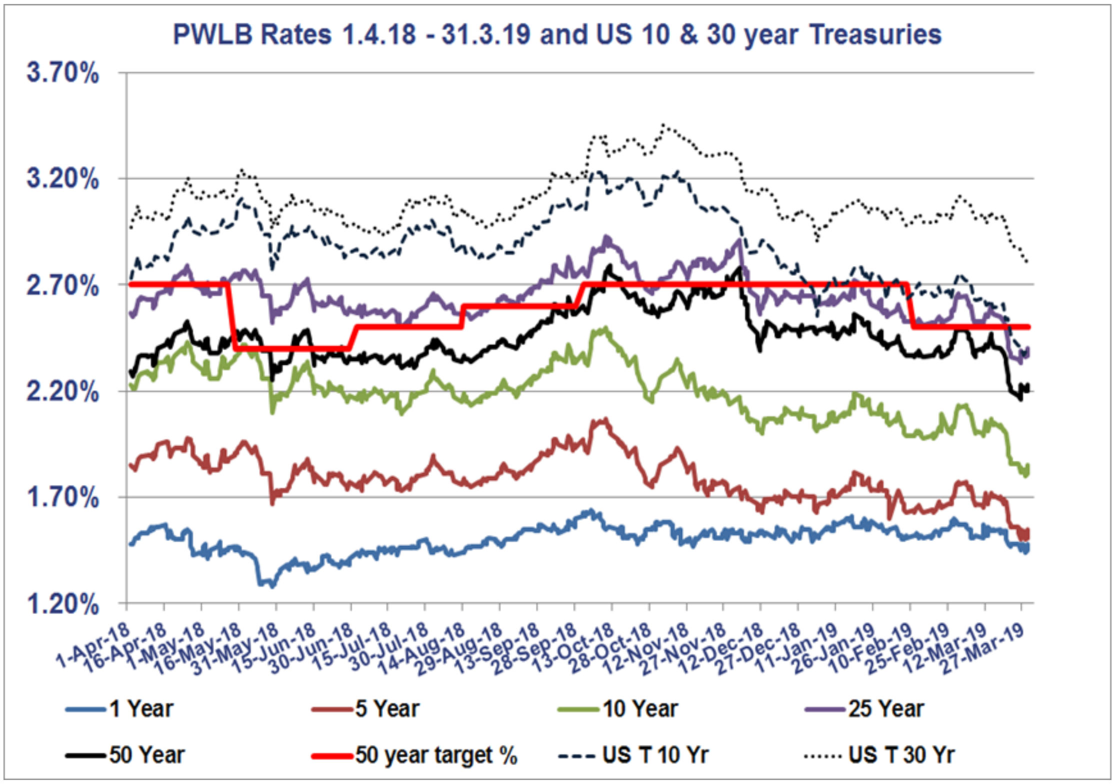
	31st March 2018 Actuals £M	31st March 2019 Budget £M	31st March 2019 Actuals £M
CFR - General Fund	306	308	310
Less NPDO	128	118	130
Net CFR	178	190	180

6. Borrowing Rates in 2018-19

Public Works Loans Board (PWLB) certainty maturity borrowing rates

The following commentary on PWLB rates during 2018-19 was provided by our treasury advisors, Link Asset Services:

Since PWLB rates peaked during October 2018, most PWLB rates have been on a general downward trend, though longer term rates did spike upwards again during December, and, (apart from the 1 year rate), reached lows for the year at the end of March. There was a significant level of correlation between movements in US Treasury yields and UK gilt yields -which determine PWLB rates. The Fed in America increased the Fed Rate four times in 2018, making nine increases in all in this cycle, to reach 2.25% – 2.50% in December. However, it had been giving forward guidance that rates could go up to nearly 3.50%. These rate increases and guidance caused Treasury yields to also move up. However financial markets considered by December 2018, that the Fed had gone too far, and discounted its expectations of further increases. Since then, the Fed has also come round to the view that there are probably going to be no more increases in this cycle. The issue now is how many cuts in the Fed Rate there will be and how soon, in order to support economic growth in the US. But weak growth now also looks to be the outlook for China and the EU so this will mean that world growth as a whole will be weak. Treasury yields have therefore fallen sharply during 2019 and gilt yields / PWLB rates have also fallen



7. Borrowing Outturn for 2018-19

Borrowing

There were no long term loans taken out during the year.

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 long term loans during the year using investment balances.

Lender	Principal	Type	Interest rate
PWLB	£0.873 m	Fixed Interest Rate	9.88%
PWLB	£0.873m	Fixed Interest Rate	9.88%
PWLB	£0.698m	Fixed Interest Rate	10.63%

Summary of debt transactions

Management of the debt portfolio resulted in a decrease in the average interest rate of 0.23% due to a decrease in long term borrowing and this has contributed to savings in loans charges in 2018-19. Savings of £0.600m have been reported and transferred to the General Fund.

8. Investment Rates in 2018-19

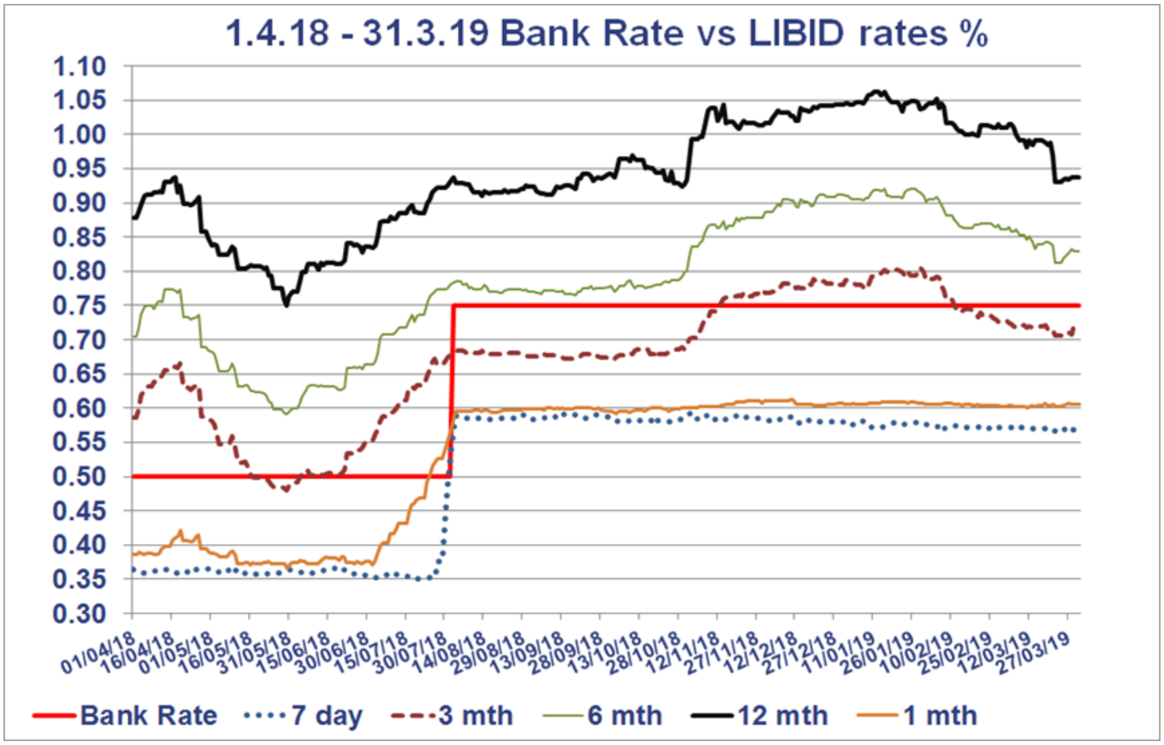
The following commentary on Investment rates during 2018-19 was provided by our treasury advisors, Link Asset Services:

Investment returns remained low during 2018/19. The expectation for interest rates within the treasury management strategy for 2018/19 was that Bank Rate would rise from 0.50% to 0.75%. At the start of 2018-19, and after UK GDP growth had proved disappointingly weak in the first few months of 2018, the expectation for the timing of this increase was pushed back from May to August 2018. Investment interest rates were therefore on a gently rising trend in the first half of the year after April, in anticipation that the MPC would raise Bank Rate in August. This duly happened at the MPC meeting on 2 August 2018.

It was not expected that the MPC would raise Bank Rate again during 2018-19 after August in view of the fact that the UK was entering into a time of major uncertainty with Brexit due in March 2019.

Investment rates were little changed during August to October but rose sharply after the MPC meeting of 1 November was unexpectedly hawkish about their perception of building inflationary pressures, particularly from rising wages. However, weak GDP growth data after December, plus increasing concerns generated by Brexit, resulted in investment rates falling back again.

Continued uncertainty in the aftermath of the 2008 financial crisis has 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.



9. Investment Outturn 2018-19

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 22 February 2018. 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 £86.5m of internally managed funds. The internally managed funds earned an average rate of return of 0.846%. The comparable performance indicator is the average 7-day LIBID rate, which was 0.507%. This generated £0.732m of interest in 2018-19.

Asset Management Fund – the Council invested the £2m Asset Management Fund in a deposit with Qatar National Bank during 2018-19 to increase the rate of return while future long term investment of the fund is being assessed. The return on the fund was £12,600 a rate of return of 1.08%. A number of options for use of the fund are being considered and reports will be brought forward in respect of those that are considered to be potential investments.

10. Prudential and Treasury Indicators

During 2018-19, 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	2017-18 Actual £000	2018-19 Original £000	2018-19 Actual £000
Net Capital expenditure	65,353	(559)	16,574
Capital Financing Requirement	306,433	307,709	310,013
Gross borrowing	307,118	301,462	313,243
External debt	178,487	179,207	183,476
Investments	69,915	50,000	75,043
Net borrowing	108,572	129,207	108,433

All investments were for less than one year, in line with the investment strategy.

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 (2017-18) plus the estimates of any additional capital financing requirement for the current (2018-19) 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 2018-19.

	2018-19
Authorised limit	£330m
Maximum gross borrowing position	£318m
Operational boundary	£322m
Average gross borrowing position	£295m
Financing costs as a proportion of net revenue stream	6.31%

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:

	31st March 2018 Actual	**2018/19 Original Limits**	**31st March 2019 Actual**
Under 12 months	£6.0m	£55.0m	£17.4m
12 months and within 24 months	£6.4m	£55.0m	£4.9m
24 months and within 5 years	£11.4m	£55.0m	£6.6m
5 years and within 10 years	£0.0m	£73.4m	£0.0m
10 years and within 20 years	£7,09m	£146.8m	£10.9m
20 years and within 30 years	£5.8m	£146.8m	£7.2m
30 years and within 40 years	£33.8m	£146.8m	£30.0m
40 years and within 50 years	£77.0m	£146.8m	£75.5m
50 years +	£31.0m	£146.8m	£31.0m
Total	£178.49m	£972.4m	£183.5m

The Council's exposure to fixed and variable interest rates in respect of borrowing was as follows which demonstrates that at the year-end the proportion of fixed and variable borrowing was within the agreed limits:

	31 March 2018 Actual	2018-19 Original Limits	31 March 2019 Actual
Fixed rate (principal or interest) based on net debt	128%	190%	133%
Variable rate (principal or interest) based on net debt	36%	60%	36%