ARGYLL AND BUTE COUNCIL	**BUSINESS CONTINUITY COMMITTEE**
FINANCIAL SERVICES	**25 JUNE 2020**

ANNUAL TREASURY REPORT 2019-20

1. EXECUTIVE SUMMARY

1.1 This report outlines the Council's Treasury Management position for 2019-20.

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 2019-20.
- During 2019-20 the Council's External Borrowing decreased by £10m from £183.5 at 31 March 2019 to £173.6m at 31 March 2020. The decrease was due repayment of borrowing of £17m, offset by £7m of new PWLB loans taken out.
- The Capital Financing Requirement (excluding NPDO and Hub School commitments) was £172.1m this is £1.5m lower than the Council's external debt. This difference is due to unexpected slippage in the Council's capital plan at the year end. The over borrowing will correct itself once the expenditure which has slipped is incurred during 2020-21.
- Investments at 31 March 2020 were £74.8m at an average rate of 0.95% compared to £75.0m at an average rate of 0.94% for 31 March 2019.
- The average investment rate of 0.94% for 2019-20 compared favourably to the average 7 day LIBID rate of 0.534% during the period. The investments generated £1.017m of interest in 2019-20.
- The Asset Management Fund was invested in First Abu Dhabi Bank to increase the rate of return while future long term investment of the fund is being assessed. The return on the fund was £22,407, a rate of return of 1.10%.

1.4 This report meets the Code requirement for a treasury annual report.

1.5 Management of the debt portfolio resulted in a decrease in the average interest rate of 0.11% due to a decrease in long term borrowing, this is due to the repayment of high interest loans and any new loans being taken out were at historically low rates of interest.

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 It is recommended that the Business Continuity Committee note and approve the Annual Treasury Report for 2019-20.

3. IMPLICATIONS

3.1 Policy – None
3.2 Financial – None
3.3 Legal – None
3.4 Human Resources – None
3.5 Fairer Scotland Duty - None
3.5.1 Equalities – None
3.5.2 Socio-Economic Duty – None
3.5.3 Islands Duty - None
3.6 Risk – None

3.7 Customer Service – None

Kirsty Flanagan
Section 95 Officer
29 May 2020

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Appendix 1 – Annual Treasury Report 2019-20

Appendix 1

ANNUAL TREASURY REPORT

2019-20

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 2019-20. 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 2019-20 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: 21 February 2019) for the financial year 2019-20.
- a mid-year (minimum) treasury update report (Policy and Resources Committee: 17 December 2019)
- 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 15 August 2019, 17 October 2019 and 20 February 2020.

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

Link Asset Services are the Council's Treasury Advisors and they have provided commentary on the current economic position. The UK position is noted below and commentary on other countries is included within Appendix a.

UK. Economic growth in 2019 has been very volatile with quarter 1 unexpectedly strong at 0.5%, quarter 2 dire at -0.2%, quarter 3 bouncing back up to +0.5% and quarter 4 flat at 0.0%, +1.1% y/y. 2020 started with optimistic business surveys pointing to an upswing in growth after the ending of political uncertainty as a result of the decisive result of the general election in December settled the Brexit issue. However, the three monthly GDP statistics in January were disappointing, being stuck at 0.0% growth. Since then, the whole world has changed as a result of the coronavirus outbreak.

It now looks likely that the closedown of whole sections of the economy will result in a fall in GDP of at least 15% in quarter two. What is uncertain, however, is the extent of the damage that will be done to businesses by the end of the lock down period, when the end of the lock down will occur, whether there could be a second wave of the outbreak, how soon a vaccine will be created and then how quickly it can be administered to the population. This leaves huge uncertainties as to how quickly the economy will recover.

Although the UK left the EU on 31 January 2020, we still have much uncertainty as to whether there will be a reasonable trade deal achieved by the end of 2020. It is also unclear as to whether the coronavirus outbreak may yet impact on the deadline of agreeing a deal by then.

After the Monetary Policy Committee (MPC) raised Bank Rate from 0.5% to 0.75% in August 2018, Brexit uncertainty caused the MPC to sit on its hands and do nothing until March 2020; at this point it was abundantly clear that the coronavirus outbreak posed a huge threat to the economy of the UK. Two emergency cuts in Bank Rate from 0.75%, therefore, occurred in March, first to 0.25% and then to 0.10%. These cuts were accompanied by an increase in quantitative easing (QE), essentially the purchases of gilts (mainly) by the Bank of England of £200bn. The Government and the Bank were also very concerned to stop people losing their jobs during this lock down period. Accordingly, the Government has introduced various schemes to subsidise both employed and self-employed jobs for three months while the country is locked down and this has now been further extended to October. It also put in place a raft of other measures to help businesses access loans from their banks, (with the Government providing guarantees to the banks against losses), to tide them over the lock down period when some firms may have little or no income.

However, at the time of writing, this leaves open a question as to whether some firms will be solvent, even if they take out such loans, and some may also choose to close as there is, and will be, insufficient demand for their services. This is a rapidly evolving situation so there may be further measures to come from the Bank and the Government. The measures to support jobs and businesses already taken by the Government will result in a huge increase in the annual budget deficit from about 2%, to nearly 11%. The ratio of debt to GDP is also likely to increase from around 80% to around 105%. In the Budget in March, the Government also announced a large increase in spending on infrastructure; this will also help the economy to recover once the lock down is ended. Provided the coronavirus outbreak is brought under control relatively swiftly, and the lock down is eased, then it is hoped that there would be a sharp recovery, but one that would take a prolonged time to fully recover previous lost momentum.

Inflation is not going to be an issue for the near future as the world economy will be heading into a recession which is already causing a glut in the supply of oil which has fallen sharply in price. Other prices will also be under downward pressure; wage inflation has also been on a downward path over the last half year and is likely to continue that trend in the current environment. While inflation could even turn negative in the Eurozone, this is currently not likely in the UK.

Employment had been growing healthily through the last year but it will obviously be heading for a big hit in the coming months. The good news over the last year is that wage inflation has been significantly higher than CPI inflation which means that consumer real spending power has been increasing and so will have provided support to GDP growth. However, while people cannot leave their homes to do non-food shopping, retail sales will also take a big hit.

3. Overall Treasury Position as at 31 March 2020

At the beginning and the end of 2019-20 the Council's treasury (excluding borrowing by PFI and finance leases) position was as follows:

	31 March 2019 Principal £m	Rate/ Return	Average Life yrs	31 March 2020 Principal £m	Rate/ Return	Average Life yrs
Total debt	***183***	***4.46%***	***24.74***	***174***	***4.35%***	***26.31***
CFR	***180***			***172***		
Over / (under) borrowing	***3***			***2***		
Total investments	***75.0***	***0.95%***		***74.8***	***0.94%***	
Net debt	**108**			**99.2**		

The Council was over borrowed by £2m at 31 March 2020, the budgeted position for 2019-20 predicted a year end under borrowed position of £8.6m. The difference of £10.6m is due to slippage of expenditure in the capital programme during 2019-20.

4. The Strategy for 2019-20

The expectation for interest rates within the treasury management strategy for 2019-20 anticipated that Bank Rate would increase over the course of the year from 0.75% to 1.25% by the end of the financial year. Due to the COVID-19 pandemic crisis, interest rates were cut twice during March 2020 and currently sit at 0.10%, there is currently no expectation of a move on this rate for the foreseeable future.

With low borrowing rates, the Council's strategy would be to take borrowing to support the capital programme. However, due to high levels of cash balances there is no requirement to borrow at present. This position will be kept under review as based on current approved capital expenditure plans, the Council still has a need to borrow in the future and it may be advantageous to secure borrowing at low rate.

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 2019 Actuals £M	31st March 2020 Budget £M	31st March 2020 Actuals £M
CFR - General Fund	310	307	296
Less NPDO	130	119	124
Net CFR	180	188	172

6. Borrowing Rates in 2019-20

Public Works Loans Board (PWLB) certainty maturity borrowing rates

The following commentary on PWLB rates during 2019-20 was provided by our treasury advisors, Link Asset Services:

There was much speculation during the second half of 2019 that bond markets were in a bubble which was driving bond prices up and yields down to historically very low levels. The context for that was heightened expectations that the US could have been heading for a recession in 2020, and a general background of a downturn in world economic growth, especially due to fears around the impact of the trade war between the US and China, together with inflation generally at low levels in most countries and expected to remain subdued; these conditions were conducive to very low bond yields.

While inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers: this means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. This has pulled down the overall level of interest rates and bond yields in financial markets over the last 30 years.

We have therefore seen, over the last year, many bond yields up to 10 years in the Eurozone turn negative. In addition, there has, at times, been an inversion of bond yields in the US whereby 10 year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession. The other side of this coin is that bond prices are elevated as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities.

Gilt yields had therefore already been on a falling trend during the last year up until the coronavirus crisis hit western economies. Since then, we have seen gilt yields fall sharply to unprecedented lows as investors have panicked in selling shares in anticipation of impending recessions in western economies, and moved cash into safe haven assets i.e. government bonds. However, major western central banks have also started quantitative easing purchases of government bonds which has acted to maintain downward pressure on government bond yields at a time when there is going to be a huge and quick expansion of government expenditure financed by issuing government bonds; (this would normally cause bond yields to rise). At the close of the day on 31 March, all gilt yields from 1 to 5 years were between 0.12 – 0.20% while even 25-year yields were at only 0.83%.

However, HM Treasury has imposed two changes of **margins over gilt yields for PWLB rates** in 2019-20 without any prior warning; the first on 9 October 2019, added an additional 1% margin over gilts to all PWLB rates. That increase was then partially reversed for some forms of borrowing on 11 March 2020, at the same time as the Government announced in the Budget a programme of increased spending on infrastructure expenditure. It also announced that there would be a consultation with local authorities on possibly further amending these margins; this was due to end on 4 June but has been extended to 31 July due to the coronavirus outbreak.

It is clear that the Treasury will no longer allow local authorities to borrow money from the PWLB to purchase commercial property if the aim is solely to generate an income stream.

Following the changes on 11 March 2020 in margins over gilt yields, the current situation is as follows:
PWLB Standard Rate is gilt plus 200 basis points (G+200bps)
PWLB Certainty Rate is gilt plus 180 basis points (G+180bps)
Local Infrastructure Rate is gilt plus 60bps (G+60bps)

As the interest forecast table for PWLB certainty rates (gilts plus 180bps) above shows, there is likely to be little upward movement in PWLB rates over the next two years as it will take economies a prolonged period to recover all the momentum they will lose in the sharp recession that will be caused during the coronavirus shut down period. Inflation is also likely to be very low during this period and could even turn negative in some major western economies during 2020-21.

7. Borrowing Outturn for 2019-20

Borrowing

The Council took the following long terms loans during the year.

Lender	Principal	Type	Interest rate	Length of Loan
PWLB	£5m	Fixed Interest Rate	2.01%	47.6 years
PWLB	£2m	Fixed Interest Rate	1.73%	49.8 years

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.

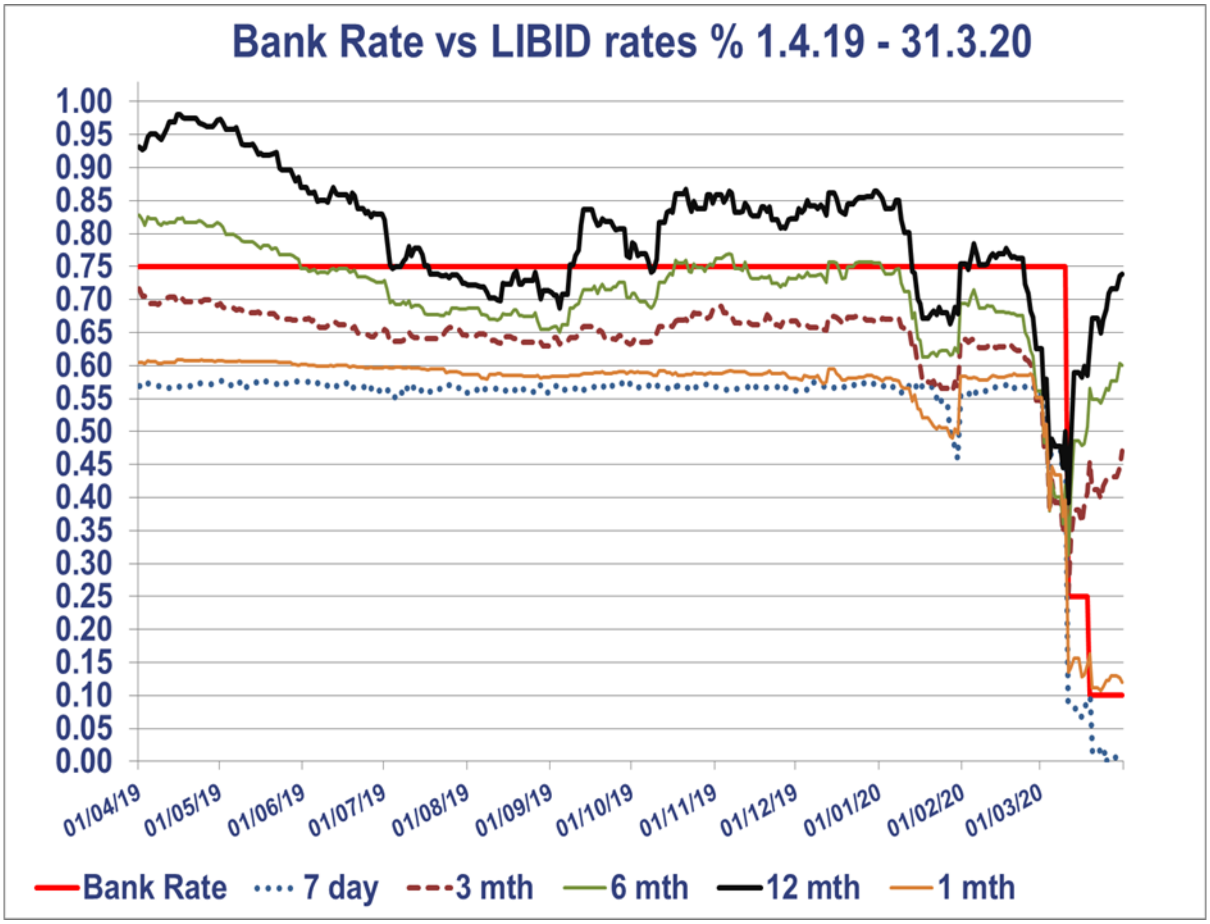
Lender	Principal	Type	Interest Rate
PWLB	£2.413 m	Fixed Interest Rate	9.38%
PWLB	£0.523 m	Fixed Interest Rate	9.75%
PWLB	£0.698 m	Fixed Interest Rate	10.00%
PWLB	£0.872 m	Fixed Interest Rate	9.88%
PWLB	£0.698 m	Fixed Interest Rate	10.50%
PWLB	£3.500 m	Fixed Interest Rate	3.51%
PWLB	£0.523 m	Fixed Interest Rate	9.75%

Summary of debt transactions: Management of the debt portfolio resulted in a decrease in the average interest rate of 0.11% due to a decrease in long term borrowing. As can be seen from the table above, high interest rate loans have been repaid and any new borrowing taken out has been at historically low rates of interest.

8. Investment Rates in 2019-20

Investment returns continued to be volatile during the greater part of the 2019-20 financial year. The expectation for interest rates within the treasury management strategy for 2019-20 was that the Bank Rate would rise from 0.75% to 1.25% over the course of the year. There was a growing expectation during the year that the MPC would gradually increase the base rate leading to the financial market building in the expected increase into investment returns. In addition, the increase in the PWLB certainty rate by 1% led to Local Authority inter- lending with some good investment returns achieved during the year in this market.

The two cuts in bank rate in March to 0.10%, as a response to the COVID-19 pandemic, has left investment returns at record low levels with little prospect for recovery in the near future. Investment decisions to forward deal in to the 2020-21 financial year will cushion the impact of these very low interest rates to a certain extent.



9. Investment Outturn 2019-20

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 21 February 2019. 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.

The Council's treasury investment portfolio was £74.8m at 31 March 2020 compared to £75.0m at 31 March 2019. The composition of the investment portfolio is shown in the table below. The internally managed funds earned an average rate of return of 0.94%. The comparable performance indicator is the average 7-day LIBID rate, which was 0.534%. This generated £1.017m of interest in 2019-20.

TREASURY PORTFOLIO					
		Actual 31.03.19 £000	**Actual 31.03.19 %**	**Actual 31.03.20 £000**	**Actual 31.03.20 %**
Treasury investments					
Banks	Clydesdale Bank	1,043	1%	242	0%
	Bank of Scotland	5,000	7%	5,000	7%
	Goldman Sachs	2,500	3%	7,500	10%
	Qatar National Bank	7,500	10%	0	0%
	Commonwealth Bank of Australia	5,000	7%	0	0%
	Santander	0	0%	7,500	10%
	ANZ Banking Group/London	7,500	10%	7,500	10%
	Bayerische Landesbank	5,000	7%	0	0%
	DBS Bank	5,000	7%	0	0%
		5,000	7%	5,000	7%
		43,543	**58%**	**32,742**	**44%**
Building Societies - rated	Nationwide Building Society	**5,000**	**7%**	**0**	**0%**
Local Authorities	Cherwell District Council	0	0%	5,000	7%
	Lancashire County Council	0	0%	7,000	9%
	Thurrock Borough Council	0	0%	5,000	7%
	Cornwall County Council	0	0%	5,000	7%
		0	**0%**	**22,000**	**29%**
Money Market Funds	Aberdeen Liquidity Sterling Fund Class L1	0	0%	7,500	10%
	Federated	3,000	4%	7,550	10%
	CCLA	6,000	8%	0	0%
	AVIVA	7,500	10%	0	0%
		16,500	**22%**	**15,050**	**20%**
Certificates of Deposit	Royal Bank of Scotland	5,000	7%	0	0%
	National Westminster Bank Plc	5,000	7%	5,000	7%
		10,000	**13%**	**5,000**	**7%**
Total Treasury Investments		**75,043**	**100%**	**74,792**	**100%**

The Council invested the £2m Asset Management Fund in a deposit with First Abu Dhabi Bank during 2019-20 to increase the rate of return while future long term investment of the fund is being assessed. The return on the fund was £22,407 a rate of return of 1.10%.

10. Prudential and Treasury Indicators

During 2019-20, 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:

	2018/19 Actual £000	2019/20 Original £000	2019/20 Actual £000
Actual Capital Expenditure	16,574	9,897	3,043
Capital Financing Requirement	310,013	307,386	296,288
Gross Borrowing	303,406	298,817	297,751
External Debt	183,476	153,490	173,639
Investments (Under 1 year)	75,043	53,000	74,792
Net Borrowing	108,433	100,490	98,847

All investments were for less than one year, in line with the investment strategy. During the year the investment strategy was changed to allow investments less than two years with local authority counterparties to be permitted.

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 (2018-19) plus the estimates of any additional capital financing requirement for the current (2019-20) 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 2019-20.

	2019-20
Authorised limit	£332m
Maximum gross borrowing position	£310m
Operational boundary	£324m
Average gross borrowing position	£307m
Financing costs as a proportion of net revenue stream	7.00%

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 2019 Actual	2018/19 Original Limits	31st March 2020 Actual
Under 12 months	£17.4m	£52.0m	£5.4m
12 months and within 24 months	£4.9m	£52.0m	£0.8m
24 months and within 5 years	£6.6m	£52.0m	£5.8m
5 years and within 10 years	£0.0m	£69.4m	£0.0m
10 years and within 20 years	£10.9m	£138.9m	£10.9m
20 years and within 30 years	£7.2m	£138.9m	£7.2m
30 years and within 40 years	£30.0m	£138.9m	£30.0m
40 years and within 50 years	£75.5m	£138.9m	£82.5m
50 years +	£31.0m	£138.9m	£31.0m
Total	£183.5m	£920.3m	£173.6m

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 2019 Actual	2019-20 Original Limits	31 March 2020 Actual
Fixed rate (principal or interest) based on net debt	133%	190%	135%
Variable rate (principal or interest) based on net debt	36%	60%	40%

Appendix a

Commentary from Link Asset Services on the Economy and Interest Rates

USA. Growth in quarter 1 of 2019 was strong at 3.1% but growth fell back to 2.0% in quarter 2 and 2.1% in quarters 3 and 4. The slowdown in economic growth resulted in the Fed cutting rates from 2.25-2.50% by 0.25% in each of July, September and October. Once coronavirus started to impact the US in a big way, the Fed took decisive action by cutting rates twice by 0.50%, and then 1.00%, in March, all the way down to 0.00 – 0.25%. Near the end of March, Congress agreed a $2trn stimulus package (worth about 10% of GDP) and new lending facilities announced by the Fed which could channel up to $6trn in temporary financing to consumers and firms over the coming months. Nearly half of the first figure is made up of permanent fiscal transfers to households and firms, including cash payments of $1,200 to individuals.

The loans for small businesses, which convert into grants if firms use them to maintain their payroll, will cost $367bn and 100% of the cost of lost wages for four months will also be covered. In addition there will be $500bn of funding from the Treasury's Exchange Stabilization Fund which will provide loans for hard-hit industries, including $50bn for airlines.

However, all this will not stop the US falling into a sharp recession in quarter 2 of 2020; some estimates are that growth could fall by as much as 40%. The first two weeks in March of initial jobless claims have already hit a total of 10 million and look headed for a total of 15m by the end of March.

EUROZONE. The annual rate of growth has been steadily falling, from 1.8% in 2018 to only 0.9% y/y in quarter 4 in 2019. The European Central Bank (ECB) ended its programme of quantitative easing purchases of debt in December 2018, which meant that the central banks in the US, UK and EU had all ended the phase of post financial crisis expansion of liquidity supporting world financial markets by purchases of debt. However, the downturn in EZ 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. At its March 2019 meeting it announced a third round of TLTROs; this provides banks with cheap two year maturity borrowing every three months from September 2019 until March 2021. However, since then, the downturn in EZ and world growth has gathered momentum so at its meeting in September 2019, it cut its deposit rate further into negative territory, from -0.4% to -0.5% and announced a resumption of quantitative easing purchases of debt to start in November at €20bn per month, a relatively small amount, plus more TLTRO measures. Once coronavirus started having a major impact in Europe, the ECB took action in March 2020 to expand its QE operations and other measures to help promote expansion of credit and economic growth. What is currently missing is a coordinated EU response of fiscal action by all national governments to protect jobs, support businesses directly and promote economic growth by expanding government expenditure on e.g. infrastructure; action is therefore likely to be patchy.

CHINA. Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium-term risks have also been increasing. The major feature of 2019 was the trade war with the US. However, this has been eclipsed by being the first country to be hit by the coronavirus outbreak; this resulted in a lock down of the country and a major contraction of economic activity in February-March 2020. While it appears that China has put a lid on the virus by the end of March, these are still early days to be confident and it is clear that the economy is going to take some time to recover its previous rate of growth. Ongoing economic issues remain, in needing to make major progress to eliminate excess industrial capacity and to switch investment from property construction and infrastructure to consumer goods production. It also needs 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. It appears to have missed much of the domestic impact from coronavirus in 2019-20 but the virus is at an early stage there.

WORLD GROWTH. The trade war between the US and China on tariffs was a major concern to financial markets and was depressing worldwide growth during 2019, as any downturn in China would spill over into impacting countries supplying raw materials to China. Concerns were particularly focused on the synchronised general weakening of growth in the major economies of the world. These concerns resulted in government bond yields in the developed world falling significantly during 2019. In 2020, coronavirus is the big issue which is going to sweep around most countries in the world and have a major impact in causing a world recession in growth in 2020.