East Lothian Council

REPORT TO:	Audit and Governance Committee
MEETING DATE:	12 June 2018
BY:	Depute Chief Executive (Resources and Peoples Services)
SUBJECT:	Annual Treasury Management Review 2017/18

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1 PURPOSE

1.1 To update the Committee on Treasury Management activity during 2017/18.

2 RECOMMENDATIONS

2.1 Members are asked to note the report.

3 BACKGROUND

3.1 The Council is required by regulations issued under the Local Government Scotland Act 2003 to produce an Annual Treasury Management Review.

3.2 The attached review updates Members on the Treasury Management activity during 2017/18.

4 POLICY IMPLICATIONS

4.1 There are no direct policy implications associated with this report; however the council's treasury management activity is determined by the policy framework set out in the approved Treasury Management Strategy.

5 INTEGRATED IMPACT ASSESSMENT

5.1 The subject of this report does not affect the wellbeing of the community or have a significant impact on equality, the environment or economy.

6 RESOURCE IMPLICATIONS

6.1 Financial – There are no direct financial implications associated with this report however the Council's Treasury Management activity clearly has a significant impact on the management of the Council's financial resources.

6.2 Personnel - none

6.3 Other - none

7 BACKGROUND PAPERS

7.1 Treasury Management Strategy 2017/18 to 2019/20 – East Lothian Council 28 March 2017.

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DATE	30 May 2018

Annual Treasury Management Review
2017/18

East Lothian Council
June 2018

ABBREVIATIONS USED IN THIS REPORT

CE Capital Economics - is the economics consultancy that provides Link Asset Services, Treasury solutions, with independent economic forecasts, briefings and research

CFR Capital financing requirement - the council's annual underlying borrowing need to finance capital expenditure and a measure of the council's total outstanding indebtedness

CIPFA Chartered Institute of Public Finance and Accountancy – the professional accounting body that oversees and sets standards in local authority finance and treasury management

CPI Consumer price inflation – the official measure of inflation adopted as a common standard by countries in the EU. It is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them.

ECB European Central Bank - the central bank for the Eurozone
EU European Union
EZ Eurozone -those countries in the EU which use the euro as their currency

Fed The Federal Reserve, often referred to simply as "the Fed," is the central bank of the United States. It was created by the Congress to provide the nation with a stable monetary and financial system.

FOMC The Federal Open Market Committee – this is the branch of the Federal Reserve Board which determines monetary policy in the USA by setting interest rates and determining quantitative easing policy. It is composed of 12 members--the seven members of the Board of Governors and five of the 12 Reserve Bank presidents.

GDP Gross domestic product – a measure of the growth and total size of the economy

G7 The group of seven countries that form an informal bloc of industrialised democracies--the United States, Canada, France, Germany, Italy, Japan, and the United Kingdom--that meets annually to discuss issues such as global economic governance, international security, and energy policy.

Gilts Gilts are bonds issued by the UK Government to borrow money on the financial markets. Interest paid by the Government on gilts is called a yield and is at a rate that is fixed for the duration until maturity of the gilt, (unless a gilt is index linked to inflation); yields therefore change inversely to the price of gilts i.e. a rise in the price of a gilt will mean that its yield will fall.

HRA Housing revenue account

IMF International Monetary Fund - the lender of last resort for national governments which get into financial difficulties

LAS Link Asset Services, Treasury solutions – the council's treasury management advisers

LIBID The London Interbank Bid Rate is a bid rate; the rate bid by banks on deposits i.e., the rate at which a bank is willing to borrow from other banks. It is the "other end" of the LIBOR (an offered, hence "ask" rate, the rate at which a bank will lend).

MPC The Monetary Policy Committee is a committee of the Bank of England, which meets for one and a half days, eight times a year, to determine monetary policy by setting the official interest rate in the United Kingdom, (the Bank of England Base Rate, commonly called Bank Rate), and by making decisions on quantitative easing.

MRP Minimum revenue provision -a statutory annual minimum revenue charge to reduce the total outstanding CFR, (the total indebtedness of a local authority)

PFI Private Finance Initiative – capital expenditure financed by the private sector i.e. not by direct borrowing by a local authority

PWLB Public Works Loan Board – this is the part of H.M. Treasury which provides loans to local authorities to finance capital expenditure

QE Quantitative easing – is an unconventional form of monetary policy where a central bank creates new money electronically to buy financial assets, like government bonds, (but may also include corporate bonds). This process aims to stimulate economic growth through increased private sector spending in the economy and also aims to return inflation up to target. These purchases increase the supply of liquidity to the economy; this policy is employed when lowering interest rates has failed to stimulate economic growth to an acceptable level and to lift inflation up to target.

Once QE has achieved its objectives of stimulating growth and inflation, QE will be reversed by selling the bonds the central bank had previously purchased, or by not replacing debt that it held which matures. The aim of this reversal is to ensure that inflation does not exceed its target once the economy recovers from a sustained period of depressed growth and inflation, and economic growth, and increases in inflation, are threatening to gather too much momentum if action is not taken to 'cool' the economy.

RPI The Retail Price Index is a measure of inflation that measures the change in the cost of a representative sample of retail goods and services. It was the UK standard for measurement of inflation until the UK changed to using the EU standard measure of inflation – CPI. The main difference between RPI and CPI is in the way that housing costs are treated. RPI is often higher than CPI.

TMSS The annual treasury management strategy statement report that all local authorities are required to submit for approval by the full council before the start of each financial year

VRP A voluntary revenue provision to repay debt, in the annual budget, which is additional to the annual MRP charge, (see above definition)

Annual Treasury Management Review 2017/18

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 2017/18. 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 2017/18 the minimum reporting requirements were that members of the Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 28/03/2017)
- a mid-year (minimum) treasury update report (Audit & Governance 28/11/2017)
- an annual review following the end of the year describing the activity compared to the strategy (this report)

The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is, therefore, 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.

The Council confirms that it has complied with the requirement under the Code to give scrutiny to all of the above treasury management reports by the Audit and Governance Committee, with the annual strategy approved by Council. Member training on treasury management issues was undertaken on 24/04/2018 in order to support members' scrutiny role.

2. The Economy and Interest Rates

During the calendar year of 2017, there was a major shift in expectations in financial markets in terms of how soon Bank Rate would start on a rising trend. After the UK economy surprised on the upside with strong growth in the second half of 2016, growth in 2017 was disappointingly weak in the first half of the year which meant that growth was the slowest for the first half of any year since 2012. The main reason for this was the sharp increase in inflation caused by the devaluation of sterling after the EU referendum, feeding increases into the cost of imports into the economy. This caused a reduction in consumer disposable income and spending power as inflation exceeded average wage increases.

Consequently, the services sector of the economy, accounting for around 75% of GDP, saw weak growth as consumers responded by cutting back on their expenditure. However, growth did pick up modestly in the second half of 2017. Consequently, market expectations during the autumn, rose significantly that the MPC would be heading in the direction of imminently raising Bank Rate. The minutes of the MPC meeting of 14 September 2017 indicated that the MPC was likely to raise Bank Rate very soon. The 2 November 2017 MPC quarterly inflation report meeting duly delivered by raising Bank Rate from 0.25% to 0.50%.

The 8 February 2018 MPC meeting minutes then revealed another sharp hardening in MPC warnings on a more imminent and faster pace of increases in Bank Rate than had previously been expected. Market expectations for increases in Bank Rate therefore, shifted considerably during the second half of 2017/18 and resulted in **investment rates** from 3 – 12 months increasing sharply during the spring quarter.

PWLB borrowing rates increased correspondingly to the above developments with the shorter term rates increasing more sharply than longer term rates. In addition, UK gilts have moved in a relatively narrow band this year, (within 25 bps for much of the year), compared to **US treasuries**. During the second half of the year, there was a noticeable trend in treasury yields being on a rising trend with the Fed raising rates by 0.25% in June, December and March, making six increases in all from the floor. The effect of these three increases was greater in shorter terms around 5 year, rather than longer term yields.

3. Overall Treasury Position as at 31 March 2018

At the beginning and the end of 2017/18 the Council's treasury (excluding borrowing by PFI and finance leases) position was as follows:

TABLE 1	31 March 2017 Principal	Rate/ Return	Average Life yrs		31 March 2018 Principal	Rate/ Return	Average Life yrs
Total debt	**£ 344m**	**4%**	**24.4**		**£ 358m**	**4%**	**24.6**
CFR	**£ 387m**				**£ 388m**		
Over / (under) borrowing	**£ (43)m**				**£ (30)m**		
Total investments	**£ 10m**				**£ 9.5m**		
Net debt	**£ 334m**				**£ 348m**		

4. The Strategy for 2017/18

The expectation for interest rates within the treasury management strategy for 2017/18 anticipated that Bank Rate would not start rising from 0.25% until quarter 2 2019 and then only increase once more before 31st March 2020. There would also be gradual rises in medium and longer term fixed borrowing rates during 2017/18 and the two subsequent financial years. 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.

During 2017/18, longer term PWLB rates were relatively volatile but with little overall direction, whereas shorter term PWLB rates were on a rising trend during the second half of the year.

5. The Borrowing Requirement and Debt

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

	31 March 2017 Actual	31 March 2018 Budget	31 March 2018 Actual
CFR General Services (£m)	218	223	209
CFR HRA (£m)	169	184	179
Total CFR (£m)	387	407	388

The General Services capital programme was significantly re-profiled during the 2017/18 financial year to align with the updated projected housing land audit figures. This resulted in the reduction in the CFR of General Services of £13M.

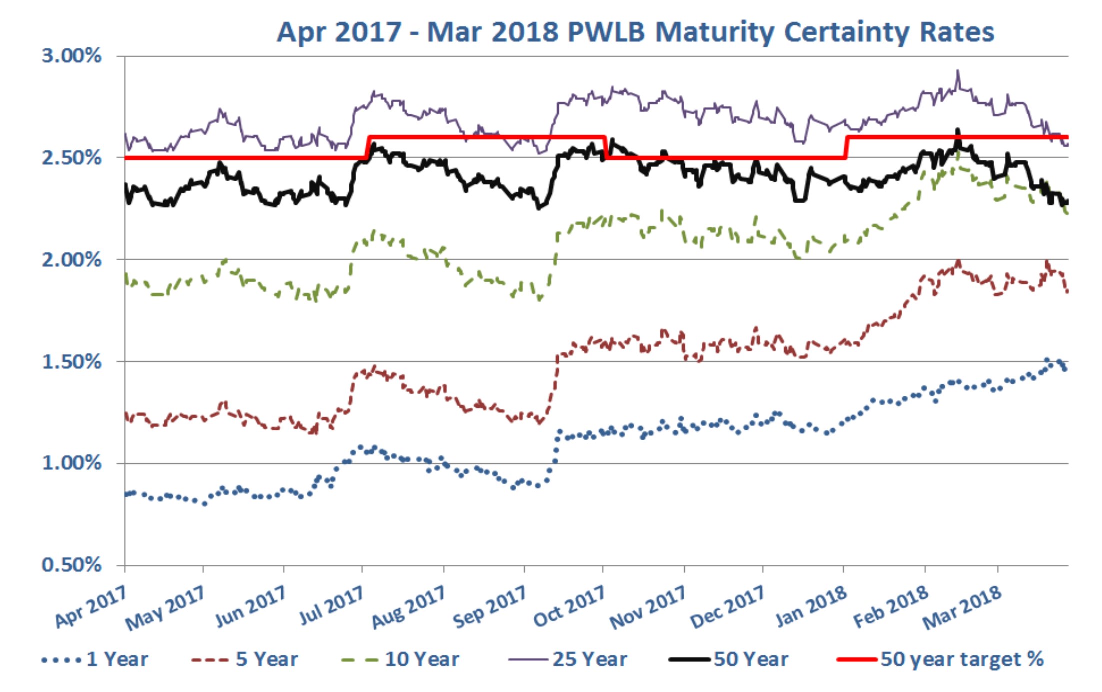
The Capital Financing Requirement of the HRA reduced due to additional asset sales being received during the 2016/17 financial year.

6. Borrowing Rates in 2017/18

PWLB certainty maturity borrowing rates

As depicted in the graph and tables below and in Appendix 2, PWLB 25 and 50 year rates have been volatile during the year with little consistent trend. However, shorter rates were on a rising trend during the second half of the year and reached peaks in February / March. During the year, the 50 year PWLB target (certainty) rate for new long term borrowing was 2.50% in quarters 1 and 3 and 2.60% in quarters 2 and 4.

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



7. Borrowing Activity for 2017/18

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

Lender	Principal	Type	Interest Rate	Maturity	Date
PWLB	£5m	Fixed interest rate	2.31%	50 years	21/12/2017
PWLB	£4m	Fixed interest rate	2.38%	10 years	15/03/2018
PWLB	£5m	Fixed interest rate	2.45%	11 years	15/03/2018
PWLB	£8m	Fixed interest rate	2.48%	48 years	15/03/2018

This compares with a budget assumption of borrowing at an interest rate of between 2.60% and 2.80%.

Repayment – the following loans were repaid during the year: -

Lender	Principal	Type	Interest Rate	Maturity	Date
PWLB	£0.662m	Fixed interest rate	8.50%	22 years	21/04/2017
PWLB	£5m	Fixed interest rate	4.02%	8 years	24/09/2017

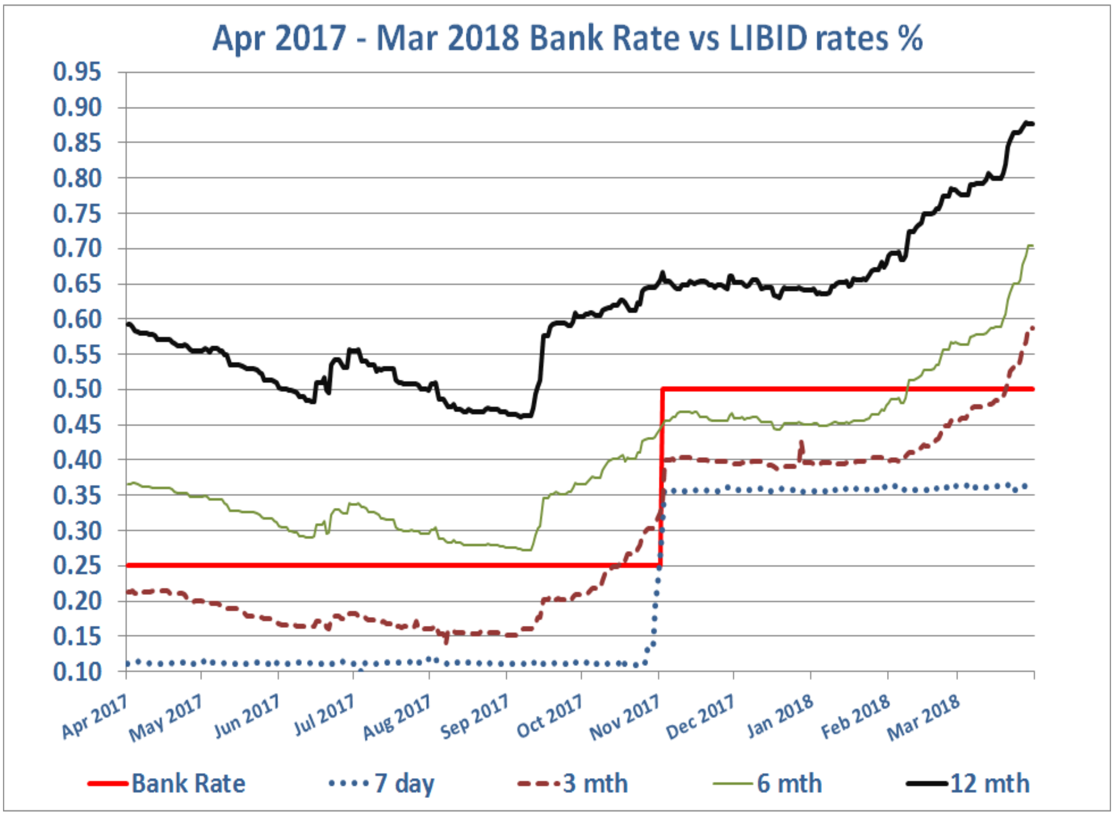
Rescheduling

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

8. Investment Rates in 2017/18

Investments rates for 3 months and longer have been on a rising trend during the second half of the year in the expectation of Bank Rate increasing from its floor of 0.25%, and reached a peak at the end of March. Bank Rate was duly raised from 0.25% to 0.50% on 2 November 2017 and remained at that level for the rest of the year. However, further increases are expected over the next few years.

Deposit rates continued into the start of 2017/18 at previous depressed levels due, in part, to a large tranche of cheap financing being made available under the Term Funding Scheme to the banking sector by the Bank of England; this facility ended on 28 February 2018.



9. Investment Activity for 2017/18

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 28 March 2017. 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 had minimal investment balances during the year as it sought to minimise its debt costs i.e. the Council temporarily used its reserves instead of external borrowing during 2017/18. It did, however, have the following loans to third parties which fall within the scope of the Councils Approved Investment Strategy:

Loan	Balance at 31/3/2017
East Lothian Housing Association	£9.429m
Dunbar Fisherman's Association	£0.020m

Investments held by fund managers– the Council uses Investec external fund managers to invest cash balances on behalf of the four Common Good Funds and ELC Charitable Trusts. The performance of the managers against the benchmark return was:

Fund Manager	Investments Held March 2017	Investments Held March 2018	Return	Benchmark
Charitable Trusts	£3.289m	£3.296m	3.5%	2.0 %
Common Good Funds	£3.363m	£3.368m	3.4%	2.0%
Total	£6.652m	£6.664m	£0.012m	

10. Other Issues

1. Revised CIPFA Codes

In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued a revised Treasury Management Code and Cross Sectoral Guidance Notes, and a revised Prudential Code.

One recommendation was that local authorities should produce a new report to members to give a high level summary of the overall capital strategy. This will form part of the annual strategy documents prepared in advance of the 2019/20 financial year.

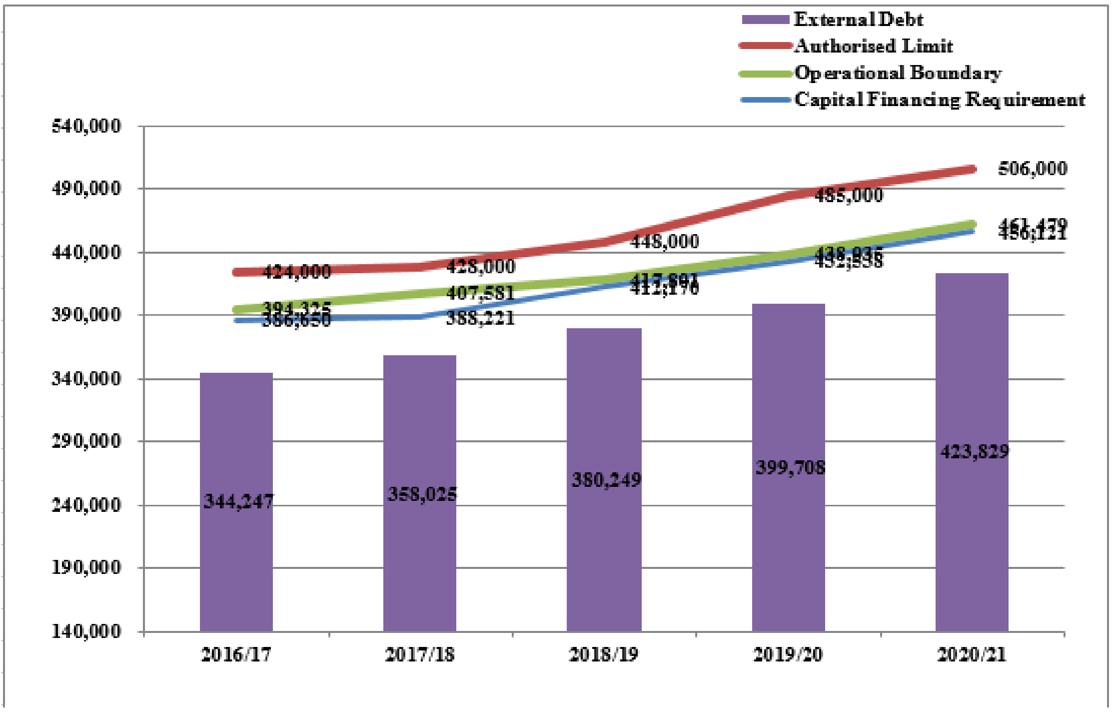
2. Markets in Financial Instruments Directive II (MiFID II)

The EU set the date of 3 January 2018 for the introduction of regulations under MIFID II. These regulations govern the relationship that financial institutions conducting lending and borrowing transactions will have with local authorities from that date. This has had little effect on this Council apart from having to fill in forms sent by each institution dealing with this Council and for each type of investment instrument we use, apart from for cash deposits with banks and building societies.

Appendix 1: Prudential and treasury indicators

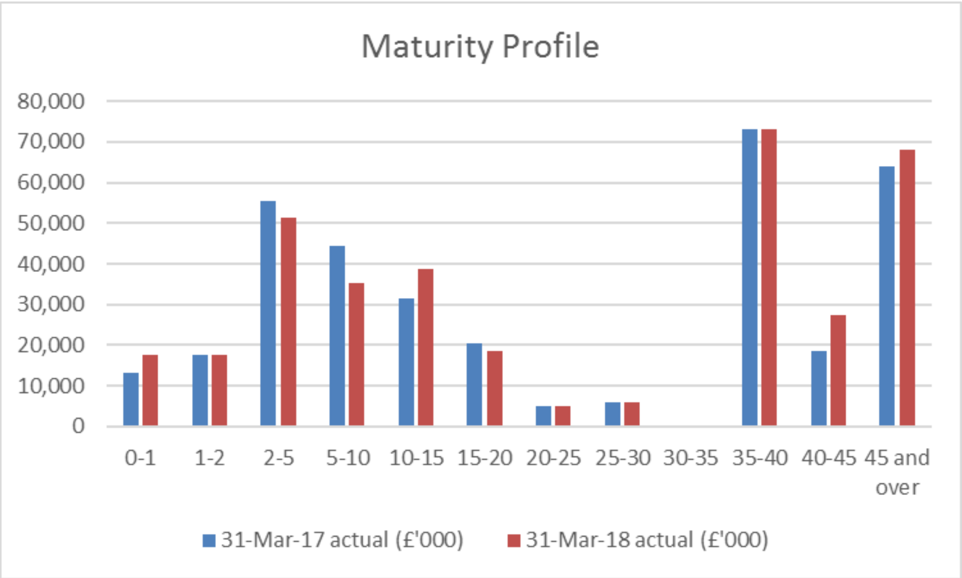
1. PRUDENTIAL INDICATORS	2016/17	2017/18	2017/18
Extract from budget	**actual**	**budget**	**actual**
	£'000	**£'000**	**£'000**
Capital Expenditure			
General Services	£ 18,559	£ 47,963	£ 29,536
HRA	£ 23,343	£ 23,421	£ 21,077
TOTAL	£ 41,902	£ 71,384	£ 50,613
Ratio of financing costs to net revenue stream			
General Services	8.53%	8.57%	8.41%
HRA	34.79%	33.18%	32.16%
Gross borrowing requirement General Services			
brought forward 1 April	£223,694	£219,913	£217,559
carried forward 31 March	£217,559	£223,312	£209,570
in year borrowing requirement	£ (6,135)	£ 3,399	£ (7,989)
Gross borrowing requirement HRA			
brought forward 1 April	£161,364	£174,412	£169,092
carried forward 31 March	£169,092	£184,269	£178,652
in year borrowing requirement	£ 7,728	£ 9,857	£ 9,560
CFR			
General Services	£217,559	£223,312	£209,570
HRA	£169,092	£184,269	£178,652
TOTAL	£386,651	£407,581	£388,222
Annual change in Capital Financing Requirement			
General Services	£ (6,135)	£ 3,399	£ (7,989)
HRA	£ 7,728	£ 9,857	£ 9,560
TOTAL	£ 1,593	£ 13,256	£ 1,571
Impact of capital investment decisions (£)			
General Services – Debt per Band D Equivalent	£ 4,958	£ 4,688	£ 4,442
HRA – Debt per dwelling	£ 19,550	£ 21,182	£20,539

2. TREASURY MANAGEMENT INDICATORS	2016/17	2017/18	2017/18
	actual	budget	actual
	£'000	£'000	£'000
Authorised Limit for external debt -			
borrowing	£419,000	£442,000	£423,000
other long term liabilities	£ 51,000	£ 40,000	£ 40,000
TOTAL	£470,000	£482,000	£463,000
Operational Boundary for external debt -			
borrowing	£398,508	£407,581	£388,221
other long term liabilities (PPP & Leases)	£ 41,306	£ 39,723	£ 39,723
TOTAL	£439,814	£447,304	£427,944
Actual external debt	£344,247	£366,780	£358,025
Gross Debt (Including PPP & Leases)	£385,565	£405,490	£396,734
Upper limit for fixed interest rate exposure			
Net principal re fixed rate borrowing	100%	100 %	100 %
Upper limit for variable rate exposure			
Net principal re variable rate borrowing	40 %	40 %	40 %
Upper limit for total principal sums invested for over 364 days (per maturity date)	£0	£0	£0



The maturity structure of the debt portfolio was as follows:

	31 March 2017 actual	31 March 2018 actual
Under 12 months	£16.11m	£17.57m
12 months and within 24 months	£17.57m	£17.60m
24 months and within 5 years	£55.64m	£51.29m
5 years and within 10 years	£44.35m	£35.24m
10 years and within 15 years	£31.56m	£38.98m
15 years and within 20 years	£20.53m	£18.38m
20 years and within 25 years	£5.00m	£5.00m
25 years and within 30 years	£5.90m	£5.90m
30 years and within 35 years	£0m	£0m
35 years and within 40 years	£73.00m	£73.00m
40 years and within 45 years	£18.50m	£27.40m
45 years and within 50 years	£63.90m	£68.00m



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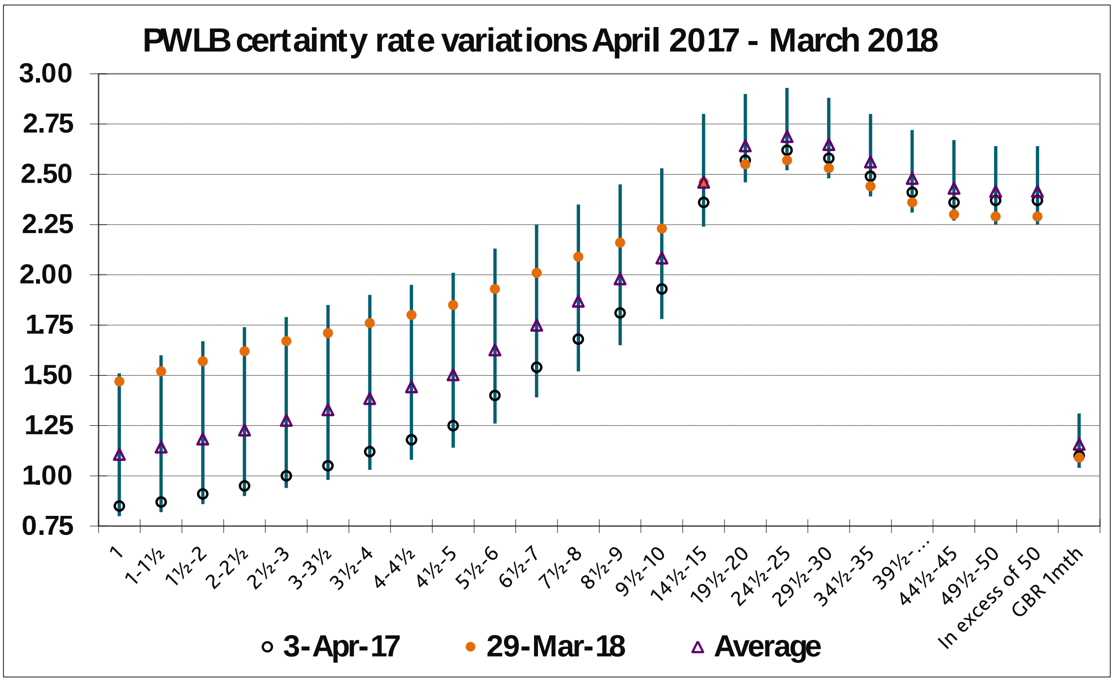
Loans Fund (£m)	31 March 2017 Actual	31 March 2018 Budget	31 March 2018 Actual
Opening balance	385	394	387
Add advances	16	28	16
Less repayments	14	15	15
Closing balance	387	407	**388**

Loans Fund - General Services (£m)	31 March 2017 Actual	31 March 2018 Budget	31 March 2018 Actual
Opening balance	224	220	218
Add advances	5	15	3
Less repayments	11	12	12
Closing balance	218	223	**209**

Loans Fund - HRA (£m)	31 March 2017 Actual	31 March 2018 Budget	31 March 2018 Actual
Opening balance	161	174	169
Add advances	11	13	13
Less repayments	3	3	3
Closing balance	169	184	**179**

Appendix 2: Borrowing and investment rates

PWLB borrowing rates



	1	1-1.5	2.5-3	3.5-4	4.5-5	9.5-10	24.5-25	49.5-50	1 month variable
3/4/17	0.850%	0.870%	1.000%	1.120%	1.250%	1.930%	2.620%	2.370%	1.100%
29/3/18	1.470%	1.520%	1.670%	1.760%	1.850%	2.230%	2.570%	2.290%	1.090%
High	1.510%	1.600%	1.790%	1.900%	2.010%	2.530%	2.930%	2.640%	1.310%
Low	0.800%	0.820%	0.940%	1.030%	1.140%	1.780%	2.520%	2.250%	1.040%
Average	1.107%	1.143%	1.276%	1.384%	1.503%	2.083%	2.688%	2.415%	1.157%
Spread	0.710%	0.780%	0.850%	0.870%	0.870%	0.750%	0.410%	0.390%	0.270%
High date	21/03/2018	21/03/2018	21/03/2018	21/03/2018	15/02/2018	15/02/2018	15/02/2018	15/02/2018	21/03/2018
Low date	03/05/2017	03/05/2017	30/05/2017	15/06/2017	15/06/2017	15/06/2017	08/09/2017	08/09/2017	04/04/2017

	1 Year	5 Year	10 Year	25 Year	50 Year
1/4/17	0.85%	1.25%	1.93%	2.62%	2.37%
31/3/18	1.47%	1.85%	2.23%	2.57%	2.29%
Low	0.80%	1.14%	1.78%	2.52%	2.25%
Date	03/05/2017	15/06/2017	15/06/2017	08/09/2017	08/09/2017
High	1.51%	2.01%	2.53%	2.93%	2.64%
Date	21/03/2018	15/02/2018	15/02/2018	15/02/2018	15/02/2018
Average	1.11%	1.50%	2.08%	2.69%	2.41%

1. Money market investment rates 2017/18

	7 day	1 month	3 month	6 month	1 year
1/4/17	0.111	0.132	0.212	0.366	0.593
31/3/18	0.364	0.386	0.587	0.704	0.878
High	0.366	0.390	0.587	0.704	0.879
Low	0.099	0.122	0.140	0.273	0.461
Average	0.215	0.233	0.286	0.401	0.606
Spread	0.267	0.268	0.447	0.432	0.418
High date	27/2/18	22/3/18	29/3/18	29/3/18	28/3/18
Low date	4/7/17	10/8/17	7/8/17	7/9/17	6/9/17