Item: 8

Policy and Resources Committee: 22 September 2020.

Treasury Management – Annual Report.

Report by Head of Finance.

1. Purpose of Report

To report on the performance of the treasury management function for financial year ended 31 March 2020.

2. Recommendations

The Committee is invited to note:

2.1.

That the Bank of England Base Rate decreased from 0.75% to 0.25% on 11 March 2020 and then reduced further to 0.10% on 19 March 2020 in response to the global Covid-19 pandemic, with the Public Works Loans Board borrowing rates reducing correspondingly, with shorter term rates decreasing more than longer term rates.

2.2.

That the strategic priority for Central Government and the Bank of England during 2019/20 was to maintain monetary and financial stability as the United Kingdom prepared to depart from the European Union but this was overtaken at the end of the financial year with the rise of the Covid-19 pandemic and the requirement to put emergency measures in place to ease the financial impact on the economy.

2.3.

That, although there remains much uncertainty over interest rates, with the long-term trend prediction for rates to rise, the Council should be well placed to benefit from savings on loan charges over the longer term.

The Committee is invited to scrutinise:

2.4.

The Annual Treasury Management Review for financial year 2019/20, attached as Appendix 1 to this report, in order to obtain assurance that the Treasury Management Practices have operated effectively.

3. Background

3.1.

Section 21 of the Financial Regulations confirms that the Council has adopted the key recommendations of Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Sector Code of Practice (the Code).

3.2.

The revised Chartered Institute of Public Finance and Accountancy's Code of Practice on Treasury Management in the Public Services (2011) further expands the definition of treasury management to include investment activities.

3.3.

The Council's investment priorities can be summarised as maintaining:

- The security of capital.
- The liquidity of its investments.

3.4.

The Council aims to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of the Council is low in order to give priority to security of its investments. This is in keeping with the nature of the Strategic Reserve Fund, which is to provide for the benefit of Orkney and its inhabitants, whilst having regard to the Fund's long term obligations in terms of the decommissioning of the Flotta Oil Terminal in the future.

3.5.

The Financial Regulations refer to maintenance of the Treasury Management Policy Statement and Treasury Management Practices as the cornerstone for effective treasury management and the requirement to report annually on the Treasury Management function.

4. Treasury Management Performance

4.1.

A detailed analysis of the Treasury Management Performance for financial year 2019/20 is attached as Appendix 1 to this report, and refers to the following activities:

- Capital Expenditure and Financing.
- The Council's Overall Borrowing Need.
- Treasury Position as at 31 March 2020.
- The Strategy for financial year 2019/20.
- Borrowing Outturn.
- Investment Outturn.

- Other Issues.

4.2.

The conclusion of the analysis of performance is that existing treasury management practices have operated effectively over the previous financial year.

4.3.

Re-profiling and slippage on the approved capital programme for financial year 2019/20 of £14,356,000 into financial year 2020/21 and beyond, has delayed the timescale over which the capital finance is required.

4.4.

The Council has established an authorised limit for external debt of £75,000,000 for the two-year period 2019 to 2021, rising to £80,000,000 in financial year 2021/22 together with an operational boundary of £60,000,000, rising to £65,000,000 during the same periods, as part of its Treasury Management Strategy for 2019/20.

4.5.

The Council supports its capital financing requirement through a combination of borrowings and use of internal reserves. In determining this combination, the cost of raising additional finance or borrowing is compared against the opportunity cost of using internal reserves and balances, in that these funds could otherwise be generating an investment return for the Council. On the basis the capital financing requirement can be externalised through borrowings, and investment returns generated in excess of the cost of any borrowings to meet the requirements of the capital programme, the potential exists for a net saving to be realised by the treasury management function over the longer term.

4.6.

As at 31 March 2020, the Council's debt portfolio stood at £35,142,625, with loan maturities ranging over periods from two to 50 years. Overall this represents an average cost of borrowing of 2.61% per annum, with an average duration of 38.76 years.

4.7.

The cost of this debt is managed as part of the loan charges associated with the capital programme and has been offset in the short term with surplus funds placed on deposit for periods of up to one year at an average rate of 1.00% for financial year 2019/20.

4.8.

The Bank of England Base Rate decreased from 0.75% to 0.25% on 11 March 2020 and then reduced further to 0.10% on 19 March 2020 in response to the global Covid-19 pandemic, with the Public Works Loans Board borrowing rates reducing correspondingly, with shorter term rates decreasing more than longer term rates.

4.9.

That the strategic priority for Central Government and the Bank of England during 2019/20 was to maintain monetary and financial stability as the United Kingdom prepared to depart from the European Union but this was overtaken at the end of the financial year with the rise of the Covid-19 pandemic and the requirement to put emergency measures in place to ease the financial impact on the economy.

4.10.

Although there remains much uncertainty over interest rates, with the long-term trend prediction for rates to rise, the Council should be well placed to benefit from savings on loan charges over the longer term.

4.11.

The prime objective for the managed funds remains to maintain or increase their real value over time, while at the same time generating an annual return which meets the targets set by the Council. These objectives normally require to be measured over a number of years while acknowledging that abnormal fluctuations in the short term do create a cause for concern.

4.12.

In February 2019 a review of the Strategic Reserve Fund managed fund investments concluded that an investment strategy with an income bias i.e. a weighting in favour of income generation better suited the Council’s needs that a strategy focused towards capital growth.

4.13.

During 2019/20, in consultation with Hymans Robertson, implementation of the new strategy progressed with interviews with potential fund managers taking place in August and October 2019 after which fund managers were appointed to three new mandates. A fourth manager was then appointed in March 2020 through the National Framework Agreement for Passive Bond mandates.

4.14.

The process to onboard the fund managers to the new mandates commenced during financial year 2019/20 but, with much of the funding activity planned for Quarter 1 of 2020, this was impacted by the financial markets’ adverse reaction to Covid-19. In the end, only £2,655,000 was drawn down by the fund manager from the Council’s commitment to the Global Private Loan Fund III in December 2019 and a further £750,000 in March 2020.

5. Corporate Governance

This report relates to the Council complying with its governance and financial processes and procedures and therefore does not directly support and contribute to improved outcomes for communities as outlined in the Council Plan and the Local Outcomes Improvement Plan.

6. Financial Implications

The financial implications are contained within the body of the report.

7. Legal Aspects

7.1.

Treasury Management arrangements help the Council meet its statutory obligation to secure best value.

7.2.

Section 40 of the Local Government in Scotland Act 2003 provides local authorities with the power to invest money. This power may be exercised in accordance with regulations made by Scottish Ministers under this section.

7.3.

Section 95 of the Local Government (Scotland) Act 1973 states that every local authority shall make arrangements for the proper administration of their financial affairs and shall secure that the proper officer has responsibility for the administration of those affairs.

8. Contact Officers

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9. Appendices

Appendix 1: Annual Treasury Management Review for financial year 2019/20.

Appendix 1.

Annual Treasury Management Review

2019/20

Contents

Annual Treasury Management Review 1
Abbreviations used in this Report 3
1. Introduction 5
2. The Council’s Capital Expenditure and Financing 5
3. The Council’s Overall Borrowing Need 6
4. Treasury Position as at 31 March 2020 7
5. The strategy for 2019/20 9
5.1. Investment strategy and control of interest rate risk 11
5.2. Borrowing strategy and control of interest rate risk 12
6. Borrowing Outturn 15
7. Investment Outturn 16
8. Other Issues 18

Abbreviations used in this Report

This is an optional area which clients may wish to include in their report if they feel that members would appreciate having this list of abbreviations and definitions.

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

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 index – 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 – th 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 System, 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 coupon and is at a rate that is fixed for the duration until maturity of the gilt, (unless a gilt is index linked to inflation); while the coupon rate is fixed, the yields will 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.

LIBID: the London Interbank Bid Rate is 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.

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, such as 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 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 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. Economic growth, and increases in inflation, may threaten 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 differences between RPI and CPI is in the way that housing costs are treated and that the former is an arithmetical mean whereas the latter is a geometric mean. RPI is often higher than CPI for these reasons.

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

Link Asset Services –

The provision of treasury management template reports currently falls within the main services that Link Asset Services provides to all clients taking our full treasury management service.

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 should receive the following reports:

- An annual treasury strategy in advance of the year (Policy and Resources Committee 19/02/2019).
- A mid-year (minimum) treasury update report (Policy and Resources Committee 26/11/2019).
- An annual review following the end of the year describing the activity compared to the strategy (Policy and Resources 22/09/2020) .

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.

This Council confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Policy and Resources Committee before they were reported to the full Council.

2. The Council's Capital Expenditure and Financing

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

£m	2018/19 Actual	2019/20 Budget	2019/20 Actual
Capital expenditure	15.083	33.288	19.920
Financed in year	11.893	17.926	12.637
Unfinanced capital expenditure	3.190	15.362	7.283

3. The Council's Overall Borrowing Need

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

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 (2019/20) plus the estimates of any additional capital financing requirement for the current (2020/21) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allowed the Council some flexibility to borrow in advance of its immediate capital needs in 2019/20. The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with this prudential indicator.

	31 March 2019 Actual	**31 March 2020 Budget**	**31 March 2020 Actual**
CFR (£m)	46.255	67.754	50.625
Gross borrowing position	30.171	45.143	35.143
Under/over funding of CFR	16.084	22.661	15.482

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

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 are 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.

	2019/20
Authorised limit	£75.000m
Maximum gross borrowing position during the year	£50.625m
Operational boundary	£60.000m
Financing costs as a proportion of net revenue stream	6.5%

4. Treasury Position as at 31 March 2020

At the beginning and the end of 2019/20 the Council's treasury position was as follows:

Debt Portfolio	**31 March 2019 Principal**	**Rate/ Return**	**Average Life years**	**31 March 2020 Principal**	**Rate/ Return**	**Average Life years**
Fixed rate funding:						
PWLB	£30.000m			£35.000m		
Salix Finance Ltd	£0.171m			£0.143m		
Total debt	£30.171m	3.82%	29.34	£35.143m	2.61%	38.68
CFR	£46.245m			£50.625m		
Over/(under) borrowing	£16.084m			£15.482m		
Total investments	£34.142m			£29.625m		
Net debt	(£3.971m)			£5.518m		

The maturity structure of the debt portfolio was as follows:

	31 March 2019 actual	**31 March 2020 actual**
Under 12 months	£5.029m	£0.029m
12 months and within 24 months	£0.029m	£0.029m
24 months and within 5 years	£5.087m	£5.085m
5 years and within 10 years	£0.026m	£0.00m
10 years and within 40 years	£0.000m	£0.000m
40 years and within 50 years	£20.000m	£30.000m

Investment Portfolio	**Actual 31.3.19 £000**	**Actual 31.3.19 %**	**Actual 31.3.20 £000**	**Actual 31.3.20 %**
Treasury Investments				
Banks	13.442	5.23	8.425	3.50
Building Societies – rated	0.000	0.00	0.000	0.00
Local Authorities	10.000	3.90	14.000	5.83
Money Market Funds	2.700	1.05	7.200	3.00
Certificate of Deposit – UK banks	8.000	3.11	0.000	0.00
Total managed in house	**34.142**	**13.29**	**29.625**	**12.33**
Equity Funds	91.548	35.63	76.695	31.92
Bond Funds	49.667	19.33	51.802	21.56
Property Funds	22.402	8.72	22.072	9.19
Diversified Growth Funds	38.522	15.00	39.378	16.39
Credit Strategies Funds	20.628	8.03	20.692	8.61
Total Strategic Reserve Fund managed externally	**222.767**	**86.71**	**210.639**	**87.67**
Total Treasury Investments	**259.909**	**100%**	**240.264**	**100%**

Non-Treasury – **Strategic Reserve Fund investments managed in-house**	**Actual 31.3.19 £000**	**Actual 31.3.19 %**	**Actual 31.3.20 £000**	**Actual 31.3.20 %**
Fishing Quota	2.688	43.90	2.769	38.37
Private Companies	3.421	55.89	4.435	61.45
Other	0.013	0.21	0.013	0.18
Total Non-Treasury Investments	**6.122**	**100%**	**7.217**	**100%**

Treasury investments (in house)	34.142	12.98	29.625	11.97
Managed Funds investments (external)	222.767	84.69	210.639	85.11
Non-Treasury investments	6.122	2.33	7.217	2.92
Total of all investments	**263.031**	**100%**	**247.481**	**100%**

5. The strategy for 2019/20

In-house funds. Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months). Greater returns are usually obtainable by investing for longer periods. While most cash balances are required in order to manage the ups and downs of cash flow, where cash sums can be identified that could be invested for longer periods, the value to be obtained from longer term investments will be carefully assessed.

- If it is thought that Bank Rate is likely to rise significantly within the time horizon being considered, then consideration will be given to keeping most investments as being short term or variable.
- Conversely, if it is thought that Bank Rate is likely to fall within that time period, consideration will be given to locking in higher rates currently obtainable, for longer periods.

Investment returns expectations

Bank Rate is forecast to stay flat at 0.50% until quarter 4 2018 and not to rise above 1.25% by quarter 1 2021. Bank Rate forecasts for financial year ends (March) are:

Financial Year.	Bank Rate.
2018/19	0.50%
2019/20	0.75%
2020/21	1.00%
2021/22	1.25%

The suggested budgeted investment earnings rates for returns on investments placed for periods up to about three months during each financial year are as follows:

Financial Year.	Now.
2018/19	0.40%
2019/20	0.60%
2020/21	0.90%
2021/22	1.25%
2021/22	1.50%
2022/23	1.75%
2023/24	2.00%
Later years	2.75%

The overall balance of risks to these forecasts is currently skewed to the upside and are dependent on how strong GDP growth turns out, how quickly inflation pressures rise and how quickly the Brexit negotiations move forward positively.

Investment treasury indicator and limit – total principal funds invested for greater than 365 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment and are based on the availability of funds after each year-end.

The Council is asked to approve the treasury indicator and limit:

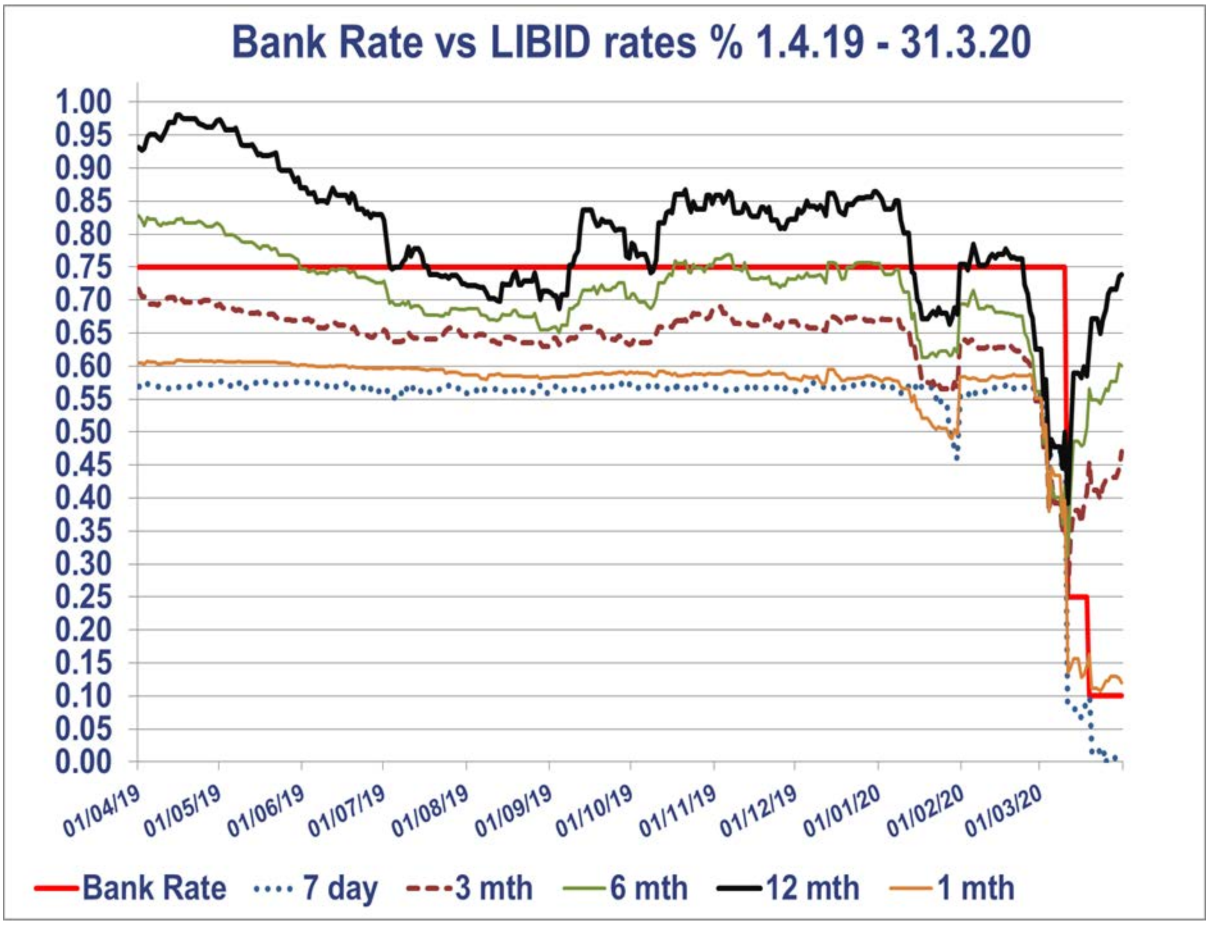
Upper limit for principal sums invested for longer than 365 days			
	2019/20	2020/21	2021/22
Principal sums invested for longer than 365 days	£70m	£70m	£70m

The budgeted investment earnings rates for returns on the Council's strategic reserve fund investments is derived from the approved investment strategy for the portfolio of investments that are managed by appointed external fund managers. A revised investment strategy was implemented in 2017, introducing a new allocation to Enhanced Yield Debt as an alternative to Government Bonds which should marginally improve investment returns going forward. This has been reflected in the forecast for the next three years as follows:

2018/2019	5.60%
2019/2020	5.60%
2020/2021	5.60%

For its cash flow generated balances, the Council will seek to utilise its business reserve instant access and notice accounts, money market funds and short-dated deposits (overnight to 365 days) in order to benefit from the compounding of interest.

5.1. Investment strategy and control of interest rate risk



Investment returns remained low during 2019/20. The expectation for interest rates within the treasury management strategy for 2019/20 was that Bank Rate would stay at 0.75% during 2019/20 as it was not expected that the MPC would be able to deliver on an increase in Bank Rate until the Brexit issue was finally settled. However, there was an expectation that Bank Rate would rise after that issue was settled, but would only rise to 1.0% during 2020.

Rising concerns over the possibility that the UK could leave the EU at the end of October 2019 caused longer term investment rates to be on a falling trend for most of April to September. They then rose after the end of October deadline was rejected by the Commons but fell back again in January before recovering again after the 31 January departure of the UK from the EU. When the coronavirus outbreak hit the UK in February/March, rates initially plunged but then rose sharply back up again due to a shortage of liquidity in financial markets. As longer term rates were significantly higher than shorter term rates during the year, value was therefore sought by placing longer term investments where cash balances were sufficient to allow this.

While the Council has taken a cautious approach to investing, it is also fully appreciative of changes to regulatory requirements for financial institutions in terms of additional capital and liquidity that came about in the aftermath of the financial crisis. These requirements have provided a far stronger basis for financial institutions, with annual stress tests by regulators evidencing how institutions are now far more able to cope with extreme stressed market and economic conditions.

Investment balances have been kept to a minimum through the agreed strategy of using reserves and balances to support internal borrowing, rather than borrowing externally from the financial markets. External borrowing would have incurred an additional cost, due to the differential between borrowing and investment rates as illustrated in the charts shown above and below. Such an approach has also provided benefits in terms of reducing the counterparty risk exposure, by having fewer investments placed in the financial markets.

5.2. Borrowing strategy and control of interest rate risk

During 2019-20, the Council maintained an under-borrowed position. This meant that the capital borrowing need, (the Capital Financing Requirement), was not fully funded with loan debt, as cash supporting the Council's reserves, balances and cash flow was used as an interim measure. This strategy was prudent as investment returns were low and minimising counterparty risk on placing investments also needed to be considered.

A cost of carry remained during the year on any new long-term borrowing that was not immediately used to finance capital expenditure, as it would have caused a temporary increase in cash balances; this would have incurred a revenue cost – the difference between (higher) borrowing costs and (lower) investment returns.

The policy of avoiding new borrowing by running down spare cash balances, has served well over the last few years. However, this was kept under review to avoid incurring higher borrowing costs in the future when this authority may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt.

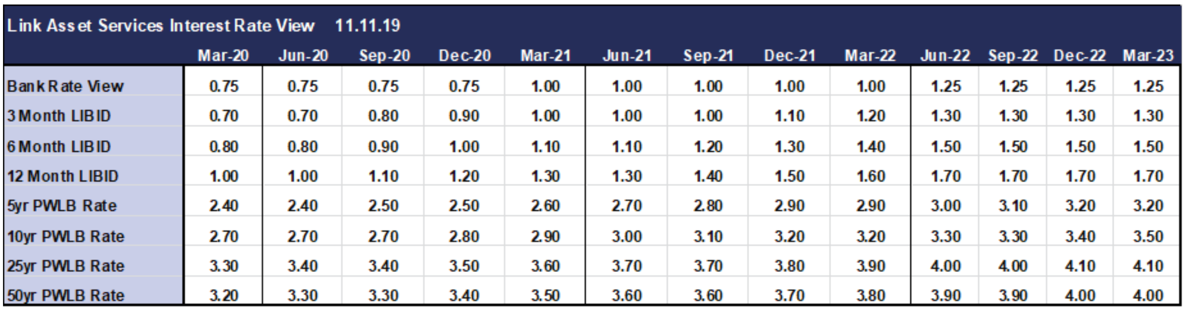
Against this background and the risks within the economic forecast, caution was adopted with the treasury operations. The Head of Finance therefore monitored interest rates in financial markets and adopted a pragmatic strategy based upon the following principles to manage interest rate risks:

- If it had been felt that there was a significant risk of a sharp FALL in long and short term rates, (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings would have been postponed, and potential rescheduling from fixed rate funding into short term borrowing would have been considered.
- If it had been felt that there was a significant risk of a much sharper RISE in long and short term rates than initially expected, perhaps arising from an acceleration in the start date and in the rate of increase in central rates in the USA and UK, an increase in world economic activity or a sudden increase in inflation risks, then the portfolio position would have been re-appraised. Most likely, fixed rate funding would have been drawn whilst interest rates were lower than they were projected to be in the next few years.

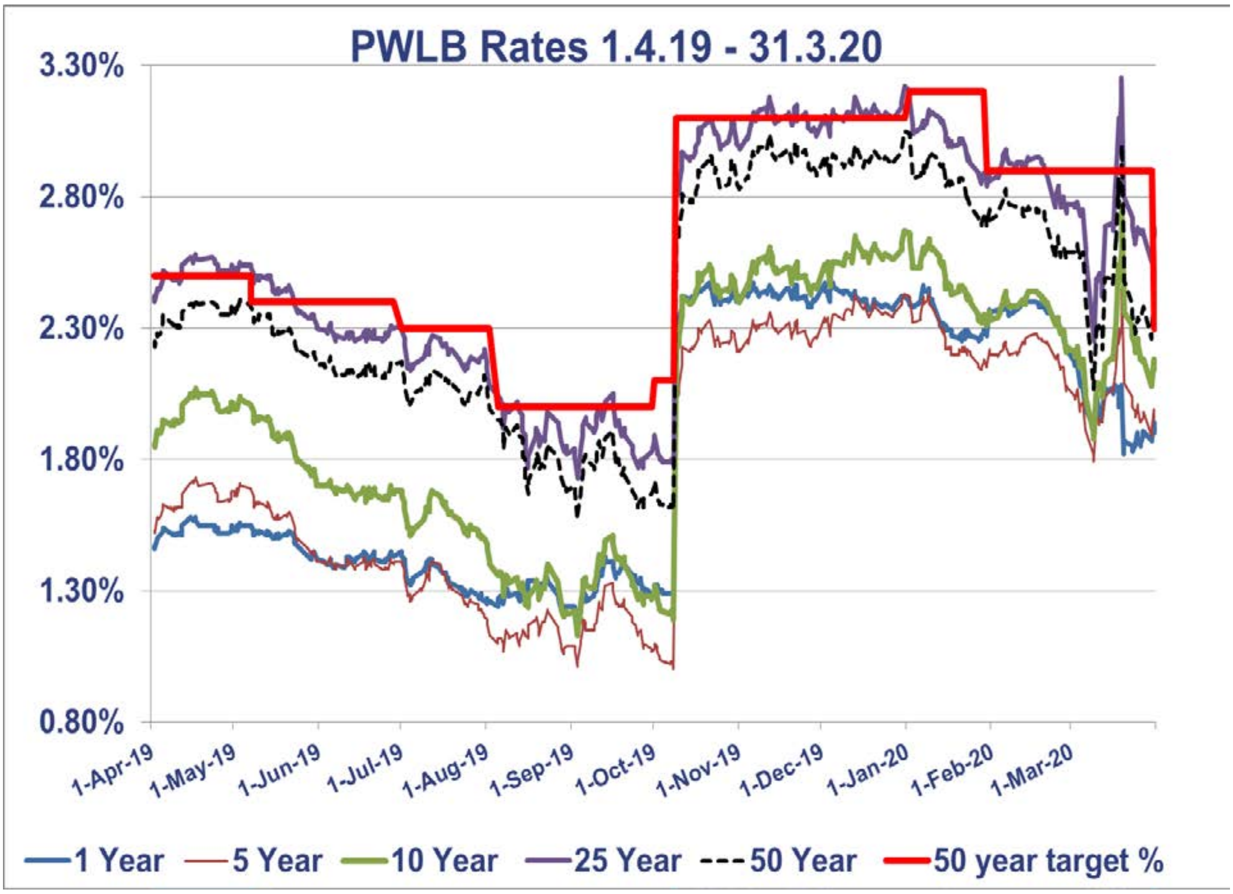
Interest rate forecasts expected only gradual rises in medium and longer term fixed borrowing rates during 2019/20 and the two subsequent financial years. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period.

The subsequent interest rate reductions that took place in March 2020 in response to the global Covid-19 pandemic had not been predicted in advance of them happening with the rates dropping to 0.25% and then 0.1% on 11 March 2020 and 19 March 2020 respectively.

The rates forecast in November 2019 by Link are shown below:



Link Asset Services Interest Rate View 11.11.19													
	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
Bank Rate View	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.25	1.25	1.25	1.25
3 Month LIBID	0.70	0.70	0.80	0.90	1.00	1.00	1.00	1.10	1.20	1.30	1.30	1.30	1.30
6 Month LIBID	0.80	0.80	0.90	1.00	1.10	1.10	1.20	1.30	1.40	1.50	1.50	1.50	1.50
12 Month LIBID	1.00	1.00	1.10	1.20	1.30	1.30	1.40	1.50	1.60	1.70	1.70	1.70	1.70
5yr PWLB Rate	2.40	2.40	2.50	2.50	2.60	2.70	2.80	2.90	2.90	3.00	3.10	3.20	3.20
10yr PWLB Rate	2.70	2.70	2.70	2.80	2.90	3.00	3.10	3.20	3.20	3.30	3.30	3.40	3.50
25yr PWLB Rate	3.30	3.40	3.40	3.50	3.60	3.70	3.70	3.80	3.90	4.00	4.00	4.10	4.10
50yr PWLB Rate	3.20	3.30	3.30	3.40	3.50	3.60	3.60	3.70	3.80	3.90	3.90	4.00	4.00



PWLB rates are based on, and are determined by, gilt (UK Government bonds) yields through HM Treasury determining a specified margin to add to gilt yields. 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 were on a generally falling trend during the last year up until the coronavirus crisis hit western economies. Since then, gilt yields have fallen 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 also started quantitative easing purchases of government bonds which will act 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 in the 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 ends on 4 June. It is clear that the Treasury intends to put a stop to local authorities borrowing 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).
- PWLB HRA Standard Rate is gilt plus 100 basis points (G+100bps).
- PWLB HRA Certainty Rate is gilt plus 80bps (G+80bps).
- Local Infrastructure Rate is gilt plus 60bps (G+60bps).

There is likely to be little upward movement in PWLB rates over the next two years as it will take national 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.

6. Borrowing Outturn

Borrowing – One £10m loan was drawn down in 2019/20 to fund the net unfinanced capital expenditure and naturally maturing debt. Notwithstanding the agreed strategy to minimise cash balances, the opportunity was taken to borrow on favourable terms at year-end in light of new commitments to the HRA capital programme and partly as a result of uncertainty over Covid-19. In doing so an under-borrowed position was still maintained, noting that we had been forecast to go cashflow negative in 2020.

The loans drawn were:

Lender	Principal	Type	Interest Rate	Maturity
PWLB	£10m	Fixed interest rate	1.28%	50 years

Borrowing in advance of need

The Council has not borrowed more than, or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed.

Repayments

On 26 May 2019 the Council repaid a £5m PWLB loan at a fixed rate of 3.51% and a further £28k towards the 8-year interest free loan with Salix Finance Ltd, which was borrowed for LED street light replacement.

The loans outstanding at 31 March 2020 were:

Lender	Principal	Type	Interest Rate	Maturity
PWLB	£5.000m	Fixed interest rate	3.93%	26/05/2022
PWLB	£10.000m	Fixed interest rate	4.28%	26/05/2060
PWLB	£10.000m	Fixed interest rate	3.54%	10/10/2064
Salix Finance Ltd	£0.143m	Interest free	0.00%	Equal Instalment of Principal – 5 years remaining
PWLB	£10.000m	Fixed interest rate	1.28%	26/03/2070
TOTAL	£35.143m	Average rate	2.61%	

7. Investment Outturn

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 19/02/2019. 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.

Resources – the Council's cash balances comprise revenue and capital resources and cash flow monies. The Council's core cash resources comprised as follows:

Balance Sheet Resources (£m)	31 March 2019	31 March 2020
Fund balances/reserves – managed in-house	8.906	7.942
Strategic Reserve Fund – externally managed	222.767	210.639
Capital Receipts	2.555	3.067
Provisions	29.866	30.590
Other	9.736	7.973
Total	**273.830**	**260.211**

Investments held by the Council

- The Council maintained an average balance of £31.883m of internally managed funds.
- The internally managed funds earned an average rate of return of 1.00%.
- The comparable performance indicator is the average 90-day LIBOR rate, which was 0.60%.
- Total investment income was £0.268m.

Investments held by fund managers

The Council employs specialist external fund managers to invest Strategic Reserve Fund cash balances across 6 separate mandates. The performance of the managers compared against the benchmark returns for the 12 months ending 31 March 2020 was:

Fund	Investments Held	Return	Benchmark
Equity Portfolio	£78.6m	-14.1%	-9.8%
Dynamic Diversified Growth Fund	£37.5m	-2.8%	3.8%
Global High Yield Credit Strategies Fund	£17.4m	-15.6%	5.8%
Global Private Loan Fund 3	£3.3m	*	*
UK Property Fund	£22.0m	-1.2%	0.1%
Fixed Income Fund	51.8m	4.2%	2.5%
Total	£210.6m	-6.9%	-3.3%

This compares with budget assumptions of 5.4% investment return. Total fund return was negative for 2019/20 with valuations citing a material uncertainty as a result of the impact of Covid-19 on the financial markets.

*Global Private Loan Fund 3 is a new mandate that has only been partly drawn down towards the end of 2019. Measuring of returns in percentages will become more appropriate when the investment has been held for a full reporting cycle.

The performance of investment mandates, including the Fund Managers, is measured against targets to out-perform the respective benchmarks over rolling 3-year periods and in some cases this has not been met, as follows:

Mandate	Benchmark	Target	Target Return	Actual Return
Equities Portfolio	45% FTSE All Share 55% MSCIAC World	+1.5% p.a. over rolling 3 years	1.0%	-2.6%
UK Property Fund **	MSCI All Balanced Property	Outperform benchmark	4.9%	4.5%
Dynamic Diversified Growth Fund	3 month LIBOR	+3% net of fees	3.7%	1.4%
Global High Yield Credit Strategies Fund	3 month LIBOR	+ 5% gross	5.8%	-15.6% *
Schroders Fixed Income Fund	ML Non-Gilts All Stocks	+0.75% p.a. over rolling 3 years	3.0%	3.4%

The global spread of Covid-19 had a dramatic effect on financial markets with the significant fall in values in the final quarter of 2019/20 dragging the 12-month and 3-year figures into negative returns.

*12-month target figures only with mandate being established in August 2017.

**Pooled fund suspended from trading due to uncertainty over property valuations as a result of Covid-19.

8. Other Issues

The Authority's activities expose it to a variety of financial risks:

- Credit risk – the possibility that other parties might fail to pay amounts due to the Authority.
- Liquidity risk – the possibility that the Authority might not have funds available to meet its commitments to make payments.
- Market risk – the possibility that financial loss might arise for the Authority as a result of changes in such measure as interest rates and stock market movements.

The Council's management of treasury risks actively works to minimise the Council's exposure to the unpredictability of financial markets and to protect the financial resources available to fund services. The Council has fully adopted CIPFA's Code of Treasury Management Practices and has written principles for overall risk management as well as written policies and procedures covering specific areas such as credit risk, liquidity risk and market risk.

Credit Risk

Credit risk arises from the short-term lending of surplus funds to financial institutions and local authorities, as well as credit exposures to the council's customers.

The risk is minimised through the Annual Investment Strategy.

Credit Risk Management Practices

The Council's credit risk management practices are set out in the Annual Investment Strategy. It is the policy of the council to place deposits only with a limited number of high quality banks, building societies and money market funds whose credit rating is independently assessed as sufficiently secure by the Council's treasury advisers and to restrict lending to a prudent maximum amount for each entity.

Deposits are not made with banks and financial institutions unless they are rated independently with minimum score of A1/P1/F1 short term debt ratings with Moodys, Standard & Poors or Fitch. The authority has a policy of not lending more than 25% of its surplus balances to individual institutions at any one time.

No credit limits were exceeded during the financial year 2019/20 and the Council expects full repayment on the due date of deposits placed with its counterparties.

Liquidity risk

The authority has a cash flow management system that seeks to ensure that cash is available as needed. If unexpected movements happen, the authority has ready access to borrowings from the money markets and the Public Works Loans Board. There is no significant risk that it will be unable to raise finance to meet its commitments under financial instruments. Instead, the risk is that the authority will be bound to replenish a significant proportion of its borrowings at a time of unfavourable interest rates. The authority sets limits on the proportion of its fixed rate borrowing during specified periods.

Market risk: interest rate risk

The Authority is exposed to risk in terms of its exposure to interest rate movements on its borrowings and investments. Movements in interest rates have a complex impact on the authority. For instance, a rise in interest rates would have the following effects:

- Borrowings at variable rates – the interest expense charged to the Surplus or Deficit on the Provision of Services will rise.
- Borrowings at fixed rates – the fair value of the liabilities borrowings will fall.
- Investments at variable rates – the interest income credited to the Surplus or Deficit on the Provision of Services will rise.
- Investments at fixed rates – the fair value of the assets will fall.

The authority's investment strategy aims to manage interest rate risk by maintaining a number of discrete investment mandates or portfolios which are managed by specialist external fund managers. The diversification across equities, multi-asset pooled funds and bond investments in this way effectively minimises the Council's exposure to interest rate movements. The risk of loss remains with the authority.

Market risk: price risk

The authority held £217.856m of investments as at 31 March 2020 in the form of equities, multi-asset pooled funds and bonds, including £3.310m in a local wind energy company and £2.769m in fishing quota. The authority is consequently exposed to losses arising from movement in the price of the shares.

The authority's investment strategy limits its exposure to price movements by diversifying its investment portfolio through the use of external fund managers, investment guidelines, benchmarks and targets.

These clearly defined shares are mainly classified as Fair Value through Profit or Loss with the investment in the local wind energy company and fishing quota classified as Fair Value Other Comprehensive Income, meaning that all movements in price will impact directly on the Surplus or Deficit in the Provision of Services.