

## **Treasury Management and Investment Strategy 2020/21 & Prudential Indicators**

### **Report by Gary Fairley, Chief Officer Corporate Solutions**

#### **1 Purpose of Report**

In accordance with the 2017 Treasury Management Code of Practice, the annual Treasury Management & Investment Strategy & Prudential Indicators report is required to be adequately scrutinised before being recommended to the Council. For Midlothian, this role is undertaken by the Audit Committee, with this report being presented to Audit Committee on 28 January 2020 prior to consideration by Council on 11 February 2020.

The purpose of the report to Council will be to seek the agreement of Council to the Treasury Management and Annual Investment Strategies for 2020/21, the Prudential and Treasury indicators contained therein, and the approach to the statutory repayment of loans fund advances.

This report is currently in draft as we do not yet have our capital grant settlement figure and are unable to finalise our budget position at this time. Nonetheless the scrutiny on the key areas/principles can still be carried out by Audit Committee as follows:-

- Borrowing strategy (Section 2.3);
- Investment Strategy & Permitted investments (Section 2.4 / Appendix 2);
- The draft Capital Financial Requirement/Authorised Limit (Section 3), noting that this reflects the capital plans to be considered by Council and could fluctuate markedly following the grant settlement;
- Changes in accounting policy in respect of the statutory repayment of loans fund advances (Section 4);

#### **2 Treasury Management & Investment Strategy 2020/21**

##### **2.1 Current Loan and Investment Portfolio**

The Council's current loan and investment portfolio, as at 10 January 2020, is shown in tables 1 and 2 below:-

Table 1: Current Loan Portfolio as at 10 January 2020

| Loan Type          | Principal Outstanding<br>£000's | Weighted Average Rate |
|--------------------|---------------------------------|-----------------------|
| PWLB Annuity       | 637                             | 8.90%                 |
| PWLB Maturity      | 198,824                         | 3.39%                 |
| LOBO               | 20,000                          | 4.51%                 |
| Market Loans       | 18,831                          | 2.68%                 |
| Salix Loans        | 803                             | 0.00%                 |
| <b>Total Loans</b> | <b>239,096</b>                  | <b>3.43%</b>          |

Table 2: Current Investment Portfolio as at 10 January 2020

| Investment Type          | Principal Outstanding<br>£000's | Weighted Average Rate |
|--------------------------|---------------------------------|-----------------------|
| Bank Call Accounts       | 0                               | n/a                   |
| Money Market Funds       | 22,134                          | 0.72%                 |
| Bank Notice Accounts     | 49,985                          | 1.20%                 |
| Other Local Authorities  | 15,000                          | 1.58%                 |
| <b>Total Investments</b> | <b>85,182</b>                   | <b>1.14%</b>          |

## 2.2 Borrowing Requirement 2019/20 to 2023/24

The Council's capital plans contain projections of capital expenditure and income over the forthcoming financial years. Any expenditure not financed directly by income, requires funding through borrowing.

The projected borrowing requirement arising from the Council's Capital Plans, and the maturing long-term loans that require to be refinanced, over the period 2019/20 to 2023/24 is shown in table 3 below:-

Table 3: Total Borrowing Requirement over the period 2019/20 to 2023/24

|   | 2019/20<br>£000's | 2020/21<br>£000's | 2021/22<br>£000's | 2022/23<br>£000's | 2023/24<br>£000's | Total<br>£000's |
|---|-------------------|-------------------|-------------------|-------------------|-------------------|-----------------|
| <b>Capital Expenditure</b>                          |                   |                   |                   |                   |                   |                 |
| General Services                                    | 36,896            | 61,305            | 70,331            | 52,577            | 28,483            | <b>249,592</b>  |
| HRA   | 29,915            | 81,128            | 64,175            | 25,423            | 14,593            | <b>215,234</b>  |
| <b>Total Capital Expenditure</b>                    | <b>66,811</b>     | <b>142,433</b>    | <b>134,506</b>    | <b>78,000</b>     | <b>43,076</b>     | <b>464,826</b>  |
| Total Available Financing                           | -33,370           | -46,792           | -41,349           | -19,098           | -13,064           | <b>-153,673</b> |
| Principal Debt Repayments                           | -8,563            | -9,305            | -11,096           | -12,912           | -13,376           | <b>-55,252</b>  |
| <b>Capital Expenditure less available Financing</b> | <b>24,878</b>     | <b>86,336</b>     | <b>82,061</b>     | <b>45,990</b>     | <b>16,636</b>     | <b>255,901</b>  |
| Maturing Long-term Loans                            | 9,219             | 9,230             | 1,471             | 1,465             | 830               | <b>22,215</b>   |
| <b>Total Borrowing Requirement</b>                  | <b>34,097</b>     | <b>95,566</b>     | <b>83,532</b>     | <b>47,455</b>     | <b>17,466</b>     | <b>278,116</b>  |
| Borrowing secured                                   | -20,000           | 0                 | 0                 | 0                 | 0                 | <b>-20,000</b>  |
| <b>Total Remaining Borrowing Requirement</b>        | <b>14,097</b>     | <b>95,566</b>     | <b>83,532</b>     | <b>47,455</b>     | <b>17,466</b>     | <b>258,116</b>  |

Note these are draft, awaiting an update post grant settlement.

The total level of borrowing noted above is required to meet the capital investment previously approved by Council for both the General Fund and HRA Capital Plans.

### **2.3 Borrowing Strategy for remainder of 2019/20 and 2020/21**

Long-term borrowing rates from the Debt Management Office's (DMO) Public Works Loans Board (PWLB) were subject to a 100bps increase applied across the tenor curve by the UK's Debt Management Office in October 2019. Despite this, medium-long term borrowing rates from both the PWLB and other market providers are currently still sitting just above historical lows and significantly below historical averages. Whilst the Council has already secured long-term borrowing for financial year 2019/20, as can be noted from Table 3 above the Council has a significant borrowing requirement across the forthcoming 4 financial years (2020/21 to 2023/24).

The current low Bank of England base rate level of 0.75% and the expectation that any base rate rises will follow a shallow upward trajectory in the short-medium term, means that continued utilisation of temporary borrowing within the Council's overall loan portfolio would continue to provide a cost-effective solution to the Council. The quantum of this will continue to be assessed against the backdrop of potential long term costs if the opportunity is missed to take PWLB or other market loans at low medium-long term rates, particularly given the projected gradual rise in PWLB rates.

Part of the Council's borrowing requirement over the current and forthcoming four financial years has already been secured through the drawdown of two £10 million maturity loans from the PWLB in September 2019, prior to the 100bps increase applied by the DMO.

It is expected that the majority of the remaining borrowing requirement to fund capital expenditure incurred in the remainder of 2019/20 and through to 2023/24 shall be sourced from a blend of internal borrowing, further temporary borrowing and by locking in to longer term PWLB borrowing to manage longer term cost and risk for the loan portfolio. However, the opportunity continues to exist to consider further loans on a 'forward dealing' basis, and officers will continue to explore the viability of these loans throughout the remainder of 2019/20 and into 2020/21.

The projected under-borrowing position as at 31 March 2020 is £40.402 million. This means that the Council have funded an equivalent amount of capital expenditure on new assets through internal resources / working capital, and have not committed to fixed long term borrowing to fund this capital expenditure through loans from external counterparties. Other options available to the Council would be to borrow a further £40.402 million from external loan providers to fully finance the capital investment which would result in an additional cost to the revenue budget; or to mature the existing £69.985 million of deposits that are cash backing the Council's reserves and defer equivalent long term borrowing over the current and forthcoming financial years, until the reserves are utilised.

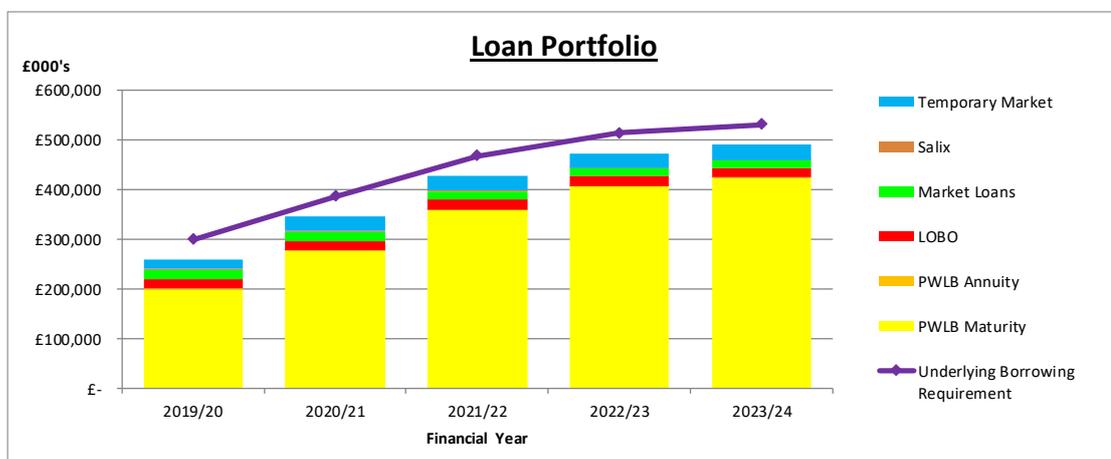
Whilst this may result in savings against the Council's current loan charges in the short term it will expose the Council to a significant risk in the medium to long term by having over £100 million exposure to interest rate and refinancing risk.

In the current climate, Council officers have assessed that the current under-borrowed position is a prudent approach which balances (a) the short-medium term cashflow benefit and saving to the revenue budget of using internal resources / working capital at a lower cost against (b) the longer-term risk of not locking into longer-term borrowing at still historically low longer term borrowing rates, particularly against the backdrop of the recent 100bps increase in PWLB rates applied by the DMO without any prior notice.

Officers will ensure that any loans taken are drawn to match the existing maturity and projected capital expenditure profiles as closely as possible, that proposed interest rates continue to sit below forward interest rate projections, and that the overall borrowing remains within the Authorised Limit proposed below.

Any other borrowing undertaken in advance of need would be supported by a business case which will appraise the anticipated savings in borrowing costs (from expected increases in rates later in the year / in forthcoming years) against the carrying cost associated with borrowing in advance of need.

The Council's projected loan portfolio over the period 2019/20 to 2023/24 is shown in graphical format below.



## 2.4 Investment Strategy

The position on potential investment opportunities remains broadly as reported to Council in the Treasury Management Mid-Year Update report on 12 November 2019.

The investment environment within which the Council seeks to invest its cash reserves remains challenging, with the continued scrutiny over the creditworthiness of counterparties resulting in an ever tighter counterparty list. At the same time, the low 0.75% Bank of England base rate dictates low returns of typically c. 1% for a 12 month fixed term deposit.

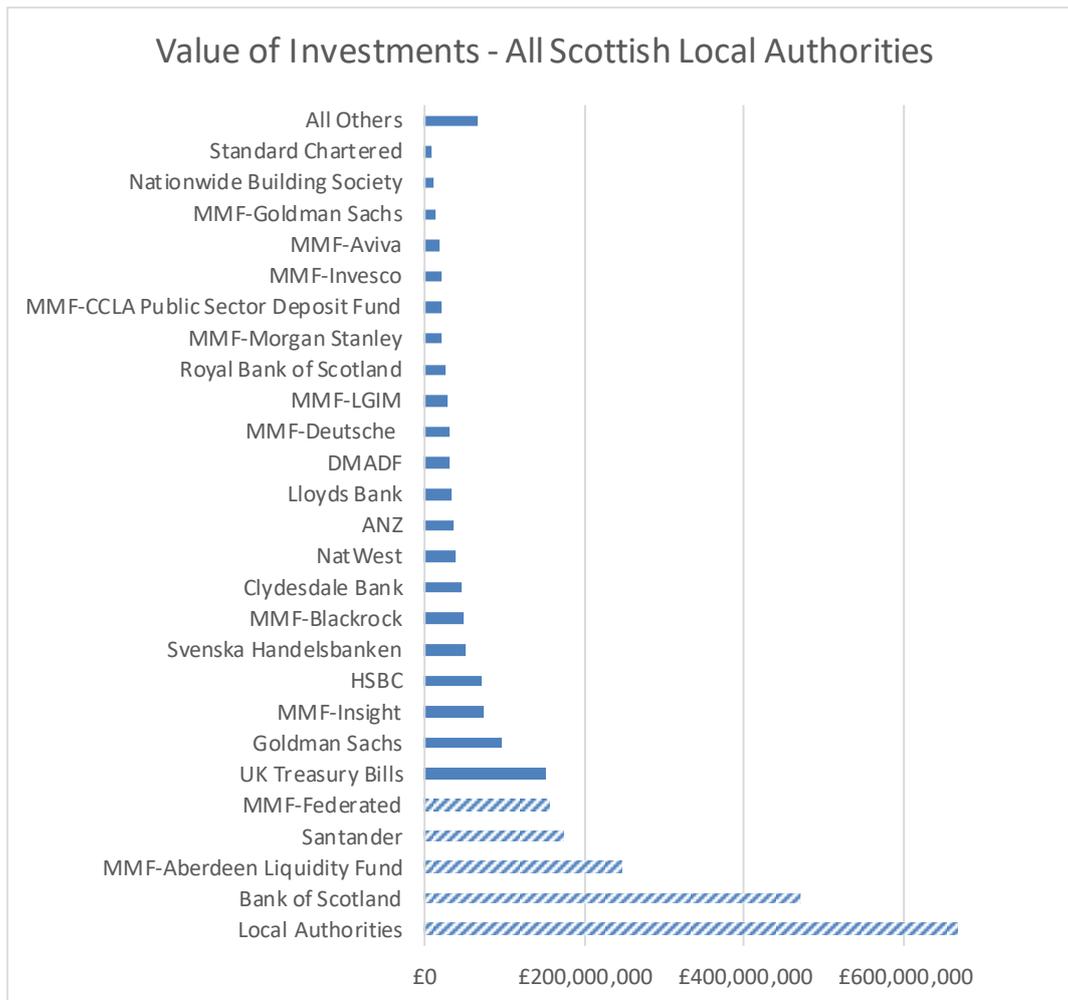
The Council currently has £69.985 million of short-term investments which have the primary aim of cash backing the Council's reserves. These are detailed in Appendix 1.

In addition, the Council currently holds £22.134 million in instant access accounts with Money Market Funds, earning a return as at the date of writing of 0.72%. These investments have the primary purpose of ensuring short-term liquidity for the Council in order to manage its day-to-day cashflow needs.

The amount held in Money Market Funds broadly reflects the Council's level of working capital and fluctuates throughout the year due to a number of factors, including cashflow fluctuations throughout the month (e.g. payrolls/council tax receipts), receipt of Scottish Government general capital (for example, £6.928 million Early Years Revenue grant funding from Scottish Government on 1 August 2019, £6.300 million Early Years Capital Grant funding from Scottish Government on 30 August 2019 and £2.042 million for new social housing 10 January 2020), general revenue and specific grants, grants from other external parties, receipt of developer contributions, and the impact of borrowing to finance the Council's capital plans and any subsequent rephasing of expenditure within these plans. The amount held in Money Market Funds throughout the current financial year is shown in Table 4 below:-

| <b>Month</b>     | <b>Minimum<br/>£000's</b> | <b>Average<br/>£000's</b> | <b>Maximum<br/>£000's</b> |
|------------------|---------------------------|---------------------------|---------------------------|
| <b>April</b>     | 5,276                     | 10,252                    | 18,353                    |
| <b>May</b>       | 9,985                     | 16,590                    | 26,742                    |
| <b>June</b>      | 8,973                     | 23,142                    | 30,089                    |
| <b>July</b>      | 5,516                     | 12,056                    | 17,947                    |
| <b>August</b>    | 6,569                     | 18,422                    | 27,218                    |
| <b>September</b> | 5,743                     | 11,620                    | 26,218                    |
| <b>October</b>   | 23,712                    | 29,267                    | 36,998                    |
| <b>November</b>  | 21,608                    | 29,055                    | 32,731                    |
| <b>December</b>  | 6,890                     | 18,067                    | 27,158                    |

Attached below is a graph showing the total level of investments held by 31 of the 32 Local Authorities in Scotland. Counterparties that the Council currently have investments with are shown as a hatched bar.



Council officers, in conjunction with Link Asset Services will continue to review the range of investment options available to the Council, within the proposed Permitted Investments included as Appendix 2, in order to select only the most creditworthy counterparties to ensure the security of Council funds, and from that list select the range of investment products that offer best value to the Council's investment portfolio.

An alternative investment strategy would be to deposit funds directly with the UK Government's Debt Management Account Deposit Facility (DMADF). All deposits with the UK DMADF would be guaranteed by HM Government and therefore have a direct claim on HM Government / the equivalent of a sovereign double-A credit rating.

Rates payable by the DMADF range from 0.50% for an overnight deposit to 0.51% for a 6 month deposit.

Were the Council to switch the entirety of its £69.985 million deposits that are currently invested with other counterparties into DMADF 6 month deposits, this would result in a loss of income to the Council of £0.490 million per annum.

### 3 Prudential Indicators

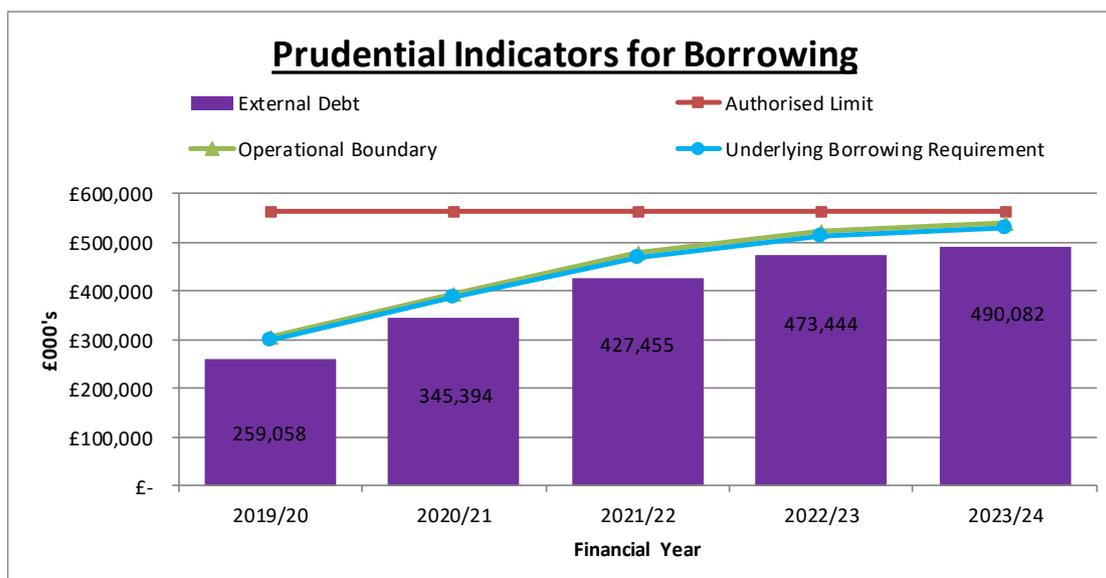
#### Prudential Code for Capital Finance in Local Authorities

The Prudential Code for Capital Finance in Local Authorities requires that Councils can demonstrate that their Capital Plans are affordable, prudent and sustainable, taking into account the financial provisions made in current and future revenue budgets; and that Treasury Management decisions are taken in accordance with good practice.

The Prudential Indicators that Councils need to consider relate to both actual, historic outcomes, and future estimated outcomes (covering the same period as the Council's Capital Plans), as follows:-

- Original indicators and actual outcomes for 2018/19;
- Revised estimates of the 2019/20 indicators; and
- Estimates of indicators for 2020/21 to 2023/24.

The Prudential Indicators required by the Code are listed individually in Appendix 3. The key indicators relating to external borrowing are shown in graphical format below.



The **Capital Financing Requirement (CFR)** denotes the Council's underlying need to borrow for capital purposes. The CFR includes borrowing arising as a result of the Council's Capital Plans, plus the long-term liability arising from the Council's two PPP contracts. The **Underlying Borrowing Requirement** strips out the latter of these (long-term liability arising from the two PPP contracts) from the CFR.

The **Authorised Limit for Borrowing** represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It is the expected maximum borrowing need with some headroom for unexpected movements.

The Authorised Limit for Borrowing has been calculated by taking the maximum value of the CFR over this year and the next 4 financial years (2020/21 to 2023/24), with the total forecast level of capital receipts and developer contributions added back to this figure (given the inherent uncertainty regarding the timing and value of these receipts/contributions). This is shown in table 5 below.

Table 5: Authorised Limit for Borrowing: Calculation

| <b>Authorised Limit</b>   | <b>Amount<br/>£000's</b> |
|---|--------------------------|
| CFR – General Services (31 March 2024)                          | 211,281                  |
| CFR – HRA (31 March 2024)                                       | 319,202                  |
| Unrealised Capital Receipts/Developer Contributions 19/20       | 1,591                    |
| Forecast Capital Receipts & Developer Contributions 20/21-23/24 | 30,277                   |
| <b>Proposed Authorised Limit</b>                                | <b>562,351</b>           |

Council will therefore be asked to approve an adjustment to the authorised limit for borrowing to £562.351 million, if market conditions support this action. This would have the effect of securing lower costs for future years but care would be taken to ensure that the cost of carry from borrowing early is minimised and that the maturity structure of all debt is sufficiently robust to ensure that the CFR at 31 March 2024 remains achievable.

The authorised limit therefore reflects a level of borrowing which, while not desired, could be afforded but is not sustainable.

#### **4 Statutory repayment of loans fund advances**

Under the Local Government Finance Circular 7/2016, Council is now required to set out its policy for the statutory repayment of loans fund advances prior to the start of each financial year. The repayment of loans fund advances ensures that the Council makes a prudent provision each year to pay off an element of the accumulated loans fund advances made in previous financial years.

Audit Committee is therefore asked to scrutinise the approach and methodology to the statutory repayment of loans fund advances and the accounting policies that dovetail together with this, prior to these being proposed and presented to Council on 11 February 2020.

##### **4.1 New Assets**

In accordance with Finance Circular 7/2016, for all advances made in relation to the provision of a new asset, the policy will be to defer the commencement of the first principal repayment of the loans fund advance until the financial year following the one in which the asset is first available for use.

##### **4.2 Loans Fund Review: Options for Prudent Repayment**

Finance Circular 7/2016 then provides a variety of options to Councils for the profiling of the repayment of each loans fund advance, so long as the principle of prudence is maintained. There are 4 options available: (a) Asset Life method; (b) Statutory method; (c) Depreciation method; and (d) Funding/income profile method.

The guidance states that Councils should be consistent when applying options; however Councils do not need to select one single option and may select different options for different capital schemes/asset classes.

(a) Asset Life method

Council officers, in conjunction with Link Asset Services, have therefore undertaken a comprehensive review of the Loans Fund accounting arrangements to assess the approach to how Loans Fund advances should prudently be repaid.

As a result of this, for those asset classes outlined in table 6 below, the Asset Life method is proposed to be adopted for the repayment of General Fund loans fund advances from 2020/21. This ensures that the repayment of the loans fund advance is reasonably commensurate with the period and pattern over which the capital expenditure provides benefits to the community and reflecting the economic benefit of assets that are now lasting longer than originally assumed, and that the period of the repayment of the loans fund advance is the same as the useful life recognised for that asset component in the Council's statutory Annual Accounts.

Table 6: Asset Classes to adopt the "Asset Life" method

| <b>Infrastructure</b>                  | <b>Current Loans Fund Advance Period*</b> | <b>Proposed Loans Fund Advance Period</b> |
|--|---|---|
| New Primary Schools/Extensions         | 50  | 60  |
| New Leisure Centres                    | 39  | 60  |
| New Offices                            | 25  | 60  |
| Road Upgrades                          | 29  | 50  |
| Street Lighting Columns                | 26  | 50  |
| Structures/Bridges                     | 26  | 50  |
| Footway/Cyclepaths                     | 30  | 50  |
| Town Centre Environmental Improvements | 20  | 50  |
| New Care Homes                         | 33  | 45  |
| Children's Play Equipment              | 9   | 20  |

*\* Average loans fund advance length*

As part of the Loans Fund Review, historic debt repayments were also reviewed to assess whether the repayment methodology applied to historic loans fund advances was still the most prudent option. As a result of this review, officers are recommending that the historic General Fund loans fund advances for the asset classes as noted in Table 6 above should also be repaid using the Asset Life method, to ensure that in line with future loans fund advances, the payments made to date can be assessed as prudent and to ensure that the repayments reasonably reflect the period over which the community receives the economic benefit of assets that are now lasting longer than originally assumed. This also ensures that the Council is not charging the borrowing cost associated with the provision of new assets to the revenue account too early (which would reduce the level of revenue budget available to support service provision).

The annual repayments under the “Asset Life” method for those asset classes as noted above will be calculated using the asset lives and will use the annuity method, to ensure consistency of approach with the Statutory method for all other asset classes (see 4.2(b) below). The annuity interest rate that will be used to calculate loans fund principal repayments under the “Asset Life” method will be the in-year loans fund rate, which for 2019/20 is currently estimated to be 3.10%.

(b) Statutory method

For all other asset classes, the policy will be to maintain the practice of previous years and apply what is termed “the Statutory Method” – following the principles of Schedule 3 of the Local Government (Scotland) Act 1975 – with all loans fund advances being repaid by the annuity method. The annuity rate that is proposed to be applied to the loans fund repayments varies will be the in-year loans fund rate, reflecting the Council’s current loan and investment portfolio. The loans fund rate for 2019/20 is forecast to be 3.10%

(c) Depreciation method

Whilst this method is not currently proposed, Council officers will continue to monitor whether it is appropriate to use this for future capital projects.

(d) Funding/income profile method

Whilst this method is not currently proposed, Council officers will continue to monitor whether it is appropriate to use this for future capital projects.

### 4.3 Outcome of Review

Applying the Asset Life method as outlined in Section 4.2(a) above results in a reduction in loans fund principal repayments over the life of the medium term financial strategy which can help support higher levels of capital expenditure at a time where resources are stretched significantly and the Council is experiencing an unprecedented level of demographic growth with resultant capital investment requirements, in particular through the evolving Learning Estate Strategy requirements.

In addition, the prior year overprovision of £7.022 million can be used to further reduce the level of loans fund advances and therefore limit the increase the Council would need to make in the revenue budget to support borrowing. In other words the current or a smaller revenue budget for loan charges can support an increase in the level of capital expenditure that can be funded. Final decision on the profile of the prior year overprovision will be made as part of finalising the 2020/21 budget, once the Capital Strategy is updated and the grant settlement is known.

The Asset Life method is the approach that the majority of councils are migrating towards for the statutory repayment of loans fund advances, with these Councils achieving similar outcomes to those set out in this paper.

## **5 Other issues**

### **5.1 Treasury Management Practices**

The Chief Officer Corporate Solutions is responsible for updating Treasury Management Practices. These are reviewed on a regular basis and were reported as part of the Treasury Management Mid-Year Review Report 2017/18 presented to Council on 07 November 2018.

### **5.2 Performance Indicators 2018/19 – comparison with other Scottish Local Authorities**

The Treasury Management Forum collates performance indicators for all Scottish Local Authorities. The indicators relating to financial year 2018/19 have been published and once again demonstrate the continuing effectiveness of the Treasury function in maximising efficiency in Treasury Management activity, with the Council continuing to have one of the lowest weighted average borrowing & investment (loans fund) rate across all Scottish mainland authorities for the sixth year out of the last eight financial years. Appendix 4 outlines the loans fund rate for each Scottish Local Authority in 2018/19.

Were the internal loans fund rate to have equated to the Scottish weighted average of 3.83%, this would have generated loan charges in 2018/19 of £18.5m. The Council's actual 2018/19 loan charges for General Services and HRA were £16.5m, representing a cash saving (compared to the Scotland average) of £2.0m in 2018/19.

## **6. Report Implications**

### **6.1 Resources**

There are no direct resource implications arising from this report.

### **6.2 Risk**

The strategies outlined in this report are designed to maintain the effectiveness of the overall risk management arrangements for Treasury activity. Providing the limits outlined in the strategies are observed they will support the controls already in place in the Treasury Management Practices within which the treasury function operates.

The Prudential Indicators contained in Appendix 3 maintain the effectiveness of the overall risk management of Capital Investment and Treasury Management.

### **6.3 Single Midlothian Plan and Business Transformation**

Themes addressed in this report:

- Community safety
- Adult health, care and housing
- Getting it right for every Midlothian child
- Improving opportunities in Midlothian
- Sustainable growth
- Business transformation and Best Value
- None of the above

### **6.4 Impact on Performance and Outcomes**

The strategies to be adopted are an integral part of the corporate aim to achieve Best Value as they seek to minimise the cost of borrowing by exercising prudent debt management and investment. This in turn helps to ensure that the Council's capital expenditure is sustainable in revenue terms.

### **6.5 Adopting a Preventative Approach**

The proposals in this report do not directly impact on the adoption of a preventative approach.

### **6.6 Involving Communities and Other Stakeholders**

Although no external consultation has taken place, cognisance has been taken of professional advice obtained from Link Asset Services, the Council's appointed Treasury Consultants.

### **6.7 Ensuring Equalities**

There are no equality issues arising from this report.

### **6.8 Supporting Sustainable Development**

There are no sustainability issues arising from this report.

### **6.9 Digital Issues**

There are no IT issues arising from this report.

## **7 Summary**

The Treasury Management and Investment Strategies outlined in this document, and in the detailed document that has been placed in the Member's Library / uploaded to the Council's Committee Management System, have been formulated to comply with the revised Codes of Practice and relevant Regulations and provide the framework for achieving best value in the management of the Council's borrowing and investment portfolios.

## 8 Recommendations

The Audit Committee is invited to comment on this report before the final report is presented to Council. In particular, the following recommendations which are proposed to be put to Council on 11 February 2020:-

- a) Approve the Treasury Management and Investment Strategy for the 2020/21 financial year, as detailed in Section 2 of this report;
- b) Approve the list of Permitted Investments outlined in Appendix 2;
- c) Adopt the Prudential Indicators contained in Appendix 3 of this report;
- d) Approve an adjustment to the Authorised Limit for Borrowing to £562.351 million (as shown in Section 3) if market conditions indicate that this is prudent;
- e) Note that the policy to repay loans fund advances for those asset classes outlined in Table 5 in Section 4.2(a) will be to use the "Asset Life" method, using an annuity approach with an interest rate equating to the in-year loans fund rate;
- f) Note that the policy to repay loans fund advances as outlined in Section 4.2(a) will be applied both prospectively and retrospectively to all loans fund advances made since 31 March 1998;
- g) Note that the policy to repay loans fund advances for all other asset classes will be the "Statutory method" as outlined in Section 4.2(b), using an annuity approach with an interest rate equating to the in-year loans fund rate;

Date:- 16 January 2020

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### Background Papers:-

Appendix 1: Current Short-term Investment Portfolio

Appendix 2:- Permitted Investments

Appendix 3:- Prudential Indicators

Appendix 4: Performance Indicators 2018/19

Appendix 5:- Treasury Management & Annual Investment Strategy Statement – 2020/21 Detailed – uploaded to Members Library on the Committee Management System