Annual Treasury Management Report 2017/18 and revisions to TMS

Report by Gary Fairley, Head of Finance & Integrated Service Support

1. Purpose of Report

The purpose of the report is to inform members of the Treasury Management activity undertaken in 2017/18, the year-end position and recommendations to amend the TMS.

2. Background

The main points arising from treasury activity in 2017/18 were:

- Total new long term borrowing taken in the year amounted to £20.000 million, comprising the following:-
  - One £10 million Maturity loan sourced from PWLB in April 2017 taking advantage of historically low PWLB rates;
  - One £10 million Equal Instalment of Principal loan sourced from Deutsche Pfandbriefbank, drawn on 29 June 2017 following loan execution and hedging of interest rate in February 2016.

- Two new investments (for a period greater than 364 days) were placed with other Local Authorities as follows:-
  - One £10 million 2 year investment with Warrington Borough Council placed on 21 March 2018, maturity 23 March 2020 on a structured basis earning 1.00% for the first year and 1.70% for the second;
  - One £5 million 2 year investment with Plymouth City Council placed on 28 March 2018, maturity 30 March 2020 on a structured basis earning 1.00% for the first year and 1.70% for the second;

- The average rate of interest paid on external debt was 3.37% in 2017/18, marginally up from 3.32% in 2016/17;

- The average rate of return on investments was 0.64% in 2017/18, exceeding the benchmark of 0.40% for the fourteenth year in succession;

- The pooled internal loans fund rate for General Fund and HRA decreased from 3.24% in 2016/17 (lowest in mainland Scotland – see Appendix 1) to 3.08% in 2017/18, which is again expected to be one of the lowest when benchmarked against all mainland Authorities in Scotland;

- Were the pooled internal loans fund rate to have equated to the Scottish weighted average of 4.20%, this would have generated

loan charges in 2017/18 of £19.7 million. The Council's actual 2017/18 loan charges for General Services and HRA were £16.3 million, representing a cash saving (compared to the Scotland average) of £3.3 million in 2017/18;

- The appointment of interest between HRA and General Fund was changed in 2017/18, with the HRA charged interest at the weighted average interest rate on the Council's long-term debt, removing interest rate risk for the HRA to support the long-term rent setting strategy. The interest charge to the General Fund provides support to the Council's medium term financial strategy and capital plans;

- No debt rescheduling was undertaken during 2017/18.

A detailed report "*Annual Treasury Management Review 2017/18*" on the activity during 2017/18 is attached as Appendix 2.

3. Changes to the TMS – Statutory repayment of loans fund advances

In accordance with Scottish Government Finance Circular 7/2016, Council is 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.

A variety of options are provided to Councils so long as a prudent provision is made each year. As noted to Council in the '*Treasury Management and Investment Strategy 2018/19 & Prudential Indicators'* report on 13 February 2018, a review of the Loans Fund accounting arrangements was being undertaken which included an assessment of the period over which Loans Fund advances are projected to be repaid, noting that the final outcome would be reflected in the both the revised Capital Strategy and reported as part of the final Treasury Management outturn position for the current year. In addition, any proposed change to the policy for the repayment of loans fund advances will be reported to Council for approval.

Following this review, the following policy on the repayment of loans fund advances is proposed:-

1. Where the loans fund advance is expected to be repaid through a future dated secured funding source e.g. a Section 75 developer contribution or capital receipt, the Council will adopt the funding/income profile method for the repayment of these advances. Where the funding or income is anticipated to be less than the capital expenditure, two separate loans fund advances will be made, one being for the value of the anticipated income, profiled to reflect that income stream, with a second loans fund advance being made for the remaining balance and repaid by applying the methodology outlined below.

   Specifically, the loans fund advance equating to the value of the anticipated income, will be charged interest over the period from when the advance is made to the point where the advance, or part

of the advance, is repaid. There will be no principal repayments charged during this period. This ensures that the repayment of these advances is matched to the income stream which funds the expenditure of the new asset.

Officers will keep under review loans fund advances that have been calculated by reference to an income stream to ensure the provision for repayment remains prudent. Where an authority identifies that the income stream is, or will be, insufficient to repay the loans fund advance, a prudent repayment profile will be adopted for that loans fund advance.

2. Where loans fund advances relate to new assets, principal repayments on the new asset will be deferred until the financial year following the one in which the asset is first available for use;
3. All loans fund advances from 2018/19 shall be repaid by the annuity method. Officers are currently reviewing the appropriate advance life and interest rate and will report back to Council at a later stage;
4. The advance life and interest rate used for all loans fund principal repayments prior to 1 April 2018 are also currently being reviewed by officers in line with item 3 above and a report outlining the impact of any change to this approach will be brought back at a later stage.

4. Other Issues

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 is presented elsewhere on today's agenda.

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 Authority apart from having to fill in forms sent by each institution dealing with this Authority and for each type of investment instrument we use, apart from for cash deposits with banks and building societies.

5. Report Implications

5.1. Resources

Although benefits from Treasury Management activity continue to accrue there are no direct financial implications or other resource issues arising from this report.

The loan charges associated with Capital Expenditure and Treasury Management activity during 2017/18 are reported in the Financial Monitoring 2017/18 – General Fund Revenue report elsewhere on today's agenda and reflected in the draft Capital Strategy.

5.2. Risk

As the Council follows the requirements of CIPFA Code of Practice and the Prudential Code this minimises the risks involved in Treasury Management activities place. For those risks that do exist there are robust and effective controls in place to further mitigate the level of risks. These include further written Treasury Management Practices, which define the responsibilities of all staff involved.

5.3. 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

5.4 Impact on Performance and Outcomes

The strategies 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.

5.5 Adopting a Preventative Approach

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

5.6 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.

5.7 Ensuring Equalities

There are no equality issues arising from this report.

5.8 Supporting Sustainable Development

There are no sustainability issues arising from this report.

5.9 IT Issues

There are no IT issues arising from this report.

6. Summary

Treasury Management activity during the year has been effective in minimising the cost of borrowing and maximising investment income within the parameters set by the strategy for the year.

7. Recommendations

It is recommended that the Council:-

a) Note the Treasury Management Annual Report for 2017/18;
b) Approve the changes to the TMS for the statutory repayment of loans fund advances as set out in Section 3.

Date 24 May 2018

Report Contact:
Gary Thomson 0131 271 3230 gary.thomson@midlothian.gov.uk

Appendices:-

Appendix 1: Loans Fund Rate Comparison with other Scottish Local Authorities
Appendix 2: Annual Treasury Management Review 2017/18
Appendix 3: Investment Benchmarking Analysis 2017/18

Appendix 1:-

Loans Fund Pooled Rate Comparison 2016/17

Council	Loans Fund Rate 2016/17
Midlothian	3.24%
Perth & Kinross	3.28%
Dumfries & Galloway	3.31%
Aberdeen City	3.49%
East Lothian	3.49%
Fife	3.69%
Inverclyde	3.72%
Aberdeenshire	3.77%
North Lanarkshire	3.82%
East Renfrewshire	3.84%
Falkirk	3.84%
Orkney	3.84%
West Dunbartonshire	3.88%
South Lanarkshire	3.92%
Dundee City	4.09%
North Ayrshire	4.17%
Highland	4.28%
West Lothian	4.31%
Scottish Borders	4.36%
East Dunbartonshire	4.38%
Glasgow City	4.39%
Stirling	4.42%
Argyll & Bute	4.43%
Renfrewshire	4.44%
Angus	4.51%
Shetland	4.52%
Moray	4.56%
South Ayrshire	4.66%
East Ayrshire	4.99%
Edinburgh City	5.06%
Clackmannanshire	5.23%
Comhairle Nan Eilean Siar	6.55%

The Pooled Loans Fund Rate combines the interest paid by the Council on money borrowed, with the interest earned by the Council on money invested, along with other charges such as internal interest allowed, premiums written off and treasury-related expenses to arrive at a weighted average “loans fund rate” figure for each authority, as noted in the final column above.

Appendix 2

Annual Treasury Management Review 2017/18

Midlothian Council
June 2018

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1. The Council's Capital Expenditure and Financing 2017/18

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.

Table 1: Capital Expenditure + Financing			
	2016/17 Actual £000	2017/18 Budget £000	2017/18 Actual £000
General Fund			
Capital Expenditure	39,423	24,263	16,984
Available Funding	19,596	14,319	13,106
Borrowing Required	**19,827**	**9,944**	**3,878**
HRA			
Capital Expenditure	23,906	41,945	10,571
Available Funding	11,681	1,289	4,989
Borrowing Required	**12,225**	**40,656**	**5,582**
General Fund and HRA			
Capital Expenditure	63,329	66,208	27,555
Available Funding	31,277	15,608	18,095
Borrowing Required	**32,052**	**50,600**	**9,460**

2. The Council's Overall Borrowing Need

The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's indebtedness. The CFR results from the capital activity of the Council and what resources have been used to pay for the capital spend. It represents the 2017/18 unfinanced capital expenditure (see above table), plus prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies (such as the Government, through the Public Works Loan Board [PWLB] or the money markets), or utilising temporary cash resources within the Council.

Reducing the CFR – the Council's underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Scheduled Debt Amortisation (or loans repayment), to reduce the CFR. This is effectively a repayment of the borrowing need. This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

The total CFR can also be reduced by:

- the application of additional capital financing resources (such as unapplied capital receipts); or
- charging more than the minimum loan repayment each year through an additional revenue charge.

The Council's CFR for the year is shown below, and represents a key prudential indicator.

Table 2: Council's Capital Financing Requirement			
	31-Mar-17	2017/18	31-Mar-18
CFR:	Actual	Budget	Actual
	£000	£000	£000
Opening balance	**£ 254,024**	**£ 275,974**	**£ 278,783**
Add Borrowing Required	£ 32,052	£ 50,600	£ 9,460
Less scheduled debt amortisation	£ (7,293)	£ (7,411)	£ (7,969)
Closing balance	**£ 278,783**	**£ 319,163**	**£ 280,274**

Borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit.

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 (2015/16) plus the estimates of any additional capital financing requirement for the current (2017/18) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2017/18. The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with this prudential indicator.

Table 3: Council's Gross Borrowing Position			
	31-Mar-17	2017/18	31-Mar-18
	Actual	Budget	Actual
	£000	£000	£000
Gross Borrowing	£ 257,303	£ 301,274	£ 241,032
CFR	£ 278,783	£ 319,163	£ 280,274

The authorised limit – this Council has kept within its authorised external borrowing limit as shown by the table below. Once this has been set, the Council does not have the power to borrow above this level.

The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached.

Table 4: Gross Borrowing against Authorised Limit / Operational Boundary	
	2017/18
Authorised limit - borrowing	£482,021
Operational boundary - borrowing	£318,647
Maximum gross borrowing position	£293,275
Average gross borrowing position	£255,524

3. Treasury Position as at 31 March 2018

The Council's debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through Member reporting detailed in the Purpose section of this report, and through officer activity detailed in the Council's Treasury Management Practices. 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 5: Treasury Position

	31 March 2017 Principal	Rate/ Return	Average Life (Yrs)	31 March 2018 Principal	Rate/ Return	Average Life (Yrs)
Debt						
Fixed Rate Debt						
PWLB	£ 197,964	3.79%	25.45	£ 197,933	3.74%	26.87
Market	£ 44,339	0.78%	6.93	£ 28,099	1.92%	20.19
Total Fixed Rate Debt	**£ 242,303**	**3.24%**	**22.06**	**£ 226,032**	**3.51%**	**26.04**
Variable Rate Debt						
PWLB	£ -	n/a	n/a	£ -	n/a	n/a
Market	£ 15,000	4.63%	33.71	£ 15,000	4.63%	32.71
Total Variable Rate Debt	**£ 15,000**	**4.63%**	**33.71**	**£ 15,000**	**4.63%**	**32.71**
Total debt/gross borrowing	**£ 257,303**	**3.32%**	**24.15**	**£ 241,032**	**3.47%**	**26.45**
CFR	**£ 276,334**			**£ 280,274**		
Over/ (under) borrowing	**£ (19,031)**			**£ (39,242)**		
Investments						
Fixed Rate Investments						
In House	£ 74,985	0.80%	0.52	£ 64,985	0.79%	0.84
With Managers	£ -	n/a	n/a	£ -	n/a	n/a
Total Fixed Rate Investments	**£ 74,985**	**0.80%**	**0.52**	**£ 64,985**	**0.79%**	**0.84**
Variable Rate Investments						
In House	£ 8,581	0.28%	0	£ 8,026	0.46%	0
With Managers	£ -	n/a	n/a	£ -	n/a	n/a
Total Variable Rate Investments	**£ 8,581**	**0.28%**	**0**	**£ 8,026**	**0.46%**	**0**
Total Investments	**£ 83,566**	**0.75%**	**0.47**	**£ 73,011**	**0.75%**	**0.75**
Net Borrowing	**£ 173,737**			**£ 168,021**		

The maturity structure of the debt portfolio was as follows:

Table 6: Maturity Structure of Debt Portfolio					
	31-Mar-17		2016/17	31-Mar-18	
	Actual		Original Limits	Actual	
	£000	%	%	£000	%
Under 12 months	£ 49,031	21%	0% to 50%	£ 23,034	10%
12 months to 2 years	£ 10,034	4%	0% to 50%	£ 8,437	4%
2 years to 5 years	£ 17,733	7%	0% to 50%	£ 9,956	4%
5 years to 10 years	£ 2,256	1%	0% to 50%	£ 1,609	1%
10 years to 20 years	£ 55,665	23%	0% to 50%	£ 55,590	23%
20 years to 30 years	£ -	0%	0% to 50%	£ 9,821	4%
30 years to 40 years	£ 80,534	34%	0% to 50%	£ 85,535	35%
40 years to 50 years	£ 37,049	16%	0% to 50%	£ 42,049	17%
50 years and above	£ 5,000	2%	0% to 50%	£ 5,000	2%
Total	**£ 257,302**	**108%**		**£ 241,031**	**100%**

The maturity structure of the investment portfolio was as follows:

Table 7: Maturity Structure of Investment Portfolio		
	31-Mar-17	31-Mar-18
	£000	£000
Investments		
Under 1 Year	£ 83,566	£ 73,011
Over 1 Year	£ -	£ -
Total	**£ 83,566**	**£ 73,011**

The exposure to fixed and variable interest rates on debt was as follows:-

Table 8: Fixed/Variable Interest Rate Exposure of Debt Portfolio					
	31-Mar-17		2016/17	31-Mar-18	
	Actual		Original Limits	Actual	
	£000	%	%	£000	%
Fixed Interest Rate Exposure	£242,302	94%	0% to 100%	£ 226,032	94%
Variable Interest Rate Exposure	£ 15,000	6%	0% to 30%	£ 15,000	6%
Total	**£257,302**	**100%**		**£ 241,032**	**100%**

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 31.3.20. 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.

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

With that in mind, the general strategy for any new borrowings required was to balance savings from the utilisation of short-term market money from other UK public sector bodies at rates available at less than base rate (0.5%), with borrowing from PWLB at historically low rates. This allowed longer-term borrowing to be undertaken in the early part of the financial year when rates were low, whilst continued use of shorter-term borrowing within the overall portfolio continued to add value.

5. The Economy and Interest Rates

UK. The outcome of the EU referendum in June 2016 resulted in a gloomy outlook and economic forecasts from the Bank of England based around an expectation of a major slowdown in UK GDP growth, particularly during the second half of 2016, which was expected to push back the first increase in Bank Rate for at least three years. Consequently, the Bank responded in August 2016 by cutting Bank Rate by 0.25% to 0.25% and making available over £100bn of cheap financing to the banking sector up to February 2018. Both measures were intended to stimulate growth in the economy. This gloom was overdone as the UK economy turned in a G7 leading growth rate of 1.8% in 2016, (actually joint equal with Germany), and followed it up with another 1.8% in 2017, (although this was a comparatively weak result compared to the US and EZ).

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; quarter 1 came in at +0.3% (+1.7% y/y) and quarter 2 was +0.3% (+1.5% y/y), which meant that growth in the first half of 2017 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 in quarter 3 to 0.5% before dipping slightly to 0.4% in quarter 4.

Consequently, market expectations during the autumn rose significantly that the MPC would be heading in the direction of imminently raising Bank Rate. The MPC meeting of 14 September provided a shock to the markets with a sharp increase in tone in the minutes where the MPC considerably hardened their wording in terms of needing to raise Bank Rate very soon. The 2 November MPC quarterly Inflation Report meeting duly delivered on this warning by withdrawing the 0.25% emergency rate cut which had been implemented in August 2016. Market debate then moved on as to whether this would be a one and done move for maybe a year or more by the MPC, or the first of a series of increases in Bank Rate over the next 2-3 years. The MPC minutes from that meeting were viewed as being dovish, i.e. there was now little pressure to raise rates by much over that time period. In particular, the GDP growth forecasts were pessimistically weak while there was little evidence of building pressure on wage increases despite remarkably low unemployment. The MPC forecast that CPI would peak at about 3.1% and chose to look through that breaching of its 2% target as this was a one off result of the devaluation of sterling caused by the result of the EU referendum. The inflation forecast showed that the MPC expected inflation to come down to near the 2% target over the two to three year time horizon. So this all seemed to add up to cooling expectations of much further action to raise Bank Rate over the next two years.

However, GDP growth in the second half of 2017 came in stronger than expected, while in the new year there was evidence that wage increases had started to rise. The 8 February MPC meeting minutes therefore revealed another sharp hardening in MPC warnings focusing on a reduction in spare capacity in the economy, weak increases in productivity, higher GDP growth forecasts and a shift of their time horizon to focus on the 18 – 24 month period for seeing inflation come down to 2%. (CPI inflation ended the year at 2.7% but was forecast to still be just over 2% within two years.) This resulted in a marked increase in expectations that there would be another Bank Rate increase in May 2018 and a bringing forward of the timing of subsequent increases in Bank Rate. This shift in market expectations 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.

As for equity markets, the FTSE 100 hit a new peak near to 7,800 in early January before there was a sharp selloff in a number of stages during the spring, replicating similar developments in US equity markets.

The major UK landmark event of the year was the inconclusive result of the general election on 8 June. However, this had relatively little impact on financial markets. However, sterling did suffer a sharp devaluation against most other currencies, although it has recovered about half of that fall since then. Brexit negotiations have been a focus of much attention and concern during the year but so far, there has been little significant hold up to making progress.

The manufacturing sector has been the bright spot in the economy, seeing stronger growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year. However, the manufacturing sector only accounts for around 11% of GDP so expansion in this sector has a much more muted effect on the average total GDP growth figure for the UK economy as a whole.

EU. Economic growth in the EU, (the UK's biggest trading partner), was lack lustre for several years after the financial crisis despite the ECB eventually cutting its main rate to -0.4% and embarking on a massive programme of quantitative easing to stimulate growth. However, growth eventually picked up in 2016 and subsequently gathered further momentum to produce an overall GDP figure for 2017 of 2.3%. Nevertheless, despite providing this massive monetary stimulus, the ECB is still struggling to get inflation up to its 2% target

and in March, inflation was still only 1.4%. It is, therefore, unlikely to start an upswing in rates until possibly towards the end of 2019.

USA. Growth in the American economy was volatile in 2015 and 2016. 2017 followed that path again with quarter 1 at 1.2%, quarter 2 3.1%, quarter 3 3.2% and quarter 4 2.9%. The annual rate of GDP growth for 2017 was 2.3%, up from 1.6% in 2016. Unemployment in the US also fell to the lowest level for 17 years, reaching 4.1% in October to February, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has been the first major western central bank to start on an upswing in rates with six increases since the first one in December 2015 to lift the central rate to 1.50 – 1.75% in March 2018. There could be a further two or three increases in 2018 as the Fed faces a challenging situation with GDP growth trending upwards at a time when the recent Trump fiscal stimulus is likely to increase growth further, consequently increasing inflationary pressures in an economy which is already operating at near full capacity. In October 2017, the Fed also became the first major western central bank to make a start on unwinding quantitative easing by phasing in a gradual reduction in reinvesting maturing debt.

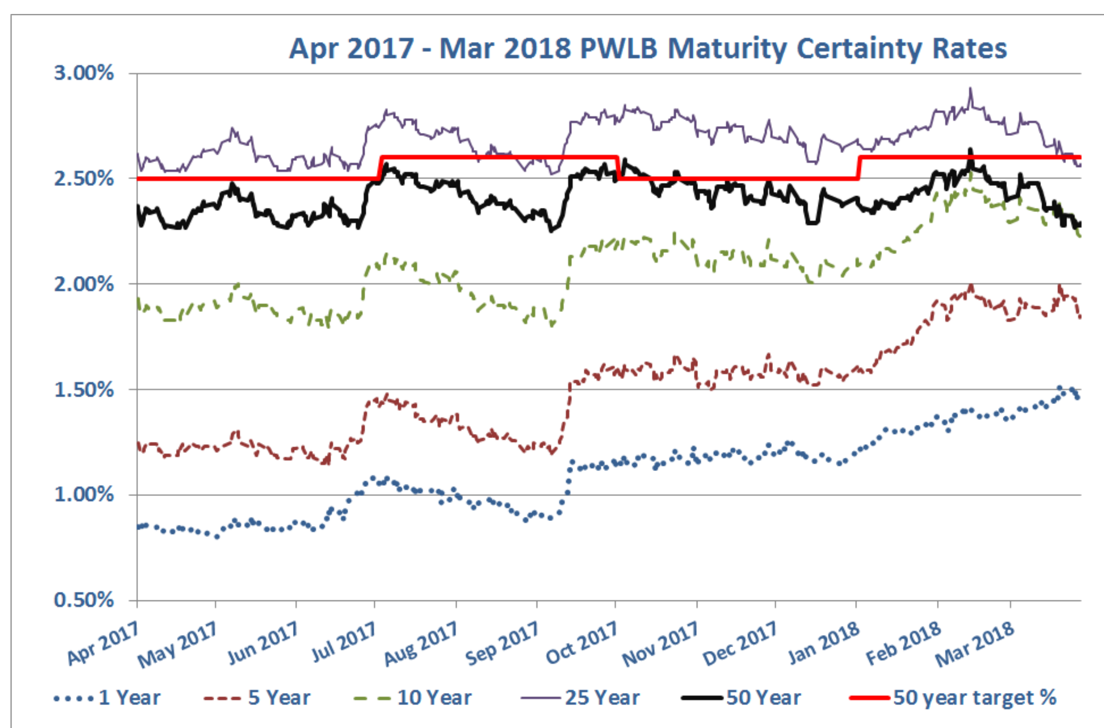
Chinese economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus and medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

Japan. GDP growth has been improving to reach an annual figure of 2.1% in quarter 4 of 2017. However, it is still struggling to get inflation up to its target rate of 2% despite huge monetary and fiscal stimulus, although inflation has risen in 2018 to reach 1.5% in February. It is also making little progress on fundamental reform of the economy.

6. Borrowing Rates in 2017/18

PWLB certainty maturity borrowing rates – As depicted in the graph and tables below and in appendix 3, 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.



Short-dated market money:- sourced from other UK public bodies, rates fluctuated throughout the year from 0.23%-0.70% for 1 to 12 month maturities.

7. Borrowing Outturn for 2017/18

New Treasury Borrowing:-

New loans were drawn to fund the net unfinanced capital expenditure and naturally maturing debt.

The loans drawn were:-

Table 9: New Loans Taken in Financial Year 2017/18						
Lender	**Date Taken**	**Principal £000's**	**Interest Rate**	**Fixed/ Variable**	**Maturity Date**	**Term (Yrs)**
PWLB	06 Apr 2017	£ 10,000	2.27%	Fixed	06 Apr 2065	48.00
Deutsche Pfandbriefbank	29 Jun 2017	£ 10,000	2.63%	Fixed	29 Jun 2045	28.00
Market	Various	£300,500	0.23%-0.60%	Variable interest rate	Various	0.08-0.17
Total		**£320,500**				

Market loans of £300.5 million reflect an average carrying value of £25.0m of Temporary Borrowing drawn on average every 1 month. This compares against a budget assumption of new short-term market borrowing of £36.5 million at an average interest rate of 0.30%.

Medium-long term borrowing of £20.0 million compares with a budget assumption of new borrowing of £39.1 million at an average interest rate of 2.79%.

Maturing Debt:-

The following table gives details of treasury debt maturing during the year:-

Table 10: Maturing Debt in Financial Year 2017/18						
Lender	**Date Repaid**	**Principal £000's**	**Interest Rate**	**Fixed/ Variable**	**Date Originally Taken**	**Original Term (Yrs)**
PWLB	Various (Annuities)	£ 31	8.72%	Fixed	Various	59.75
PWLB	29 Jun 2017	£ 10,000	3.26%	Fixed	29 Jun 2011	24.70
Salix	Various	£ 61	0.00%	Fixed	Various	7-8 years
Deutsche Pfandbriefbank	29-Dec-17	£ 179	2.63%	Fixed	29 Jun 2017	28.00
Market	Various	£326,500	0.23%-0.60%	Variable interest rate	Various	0.08-0.17
Total		**£336,771**				

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.

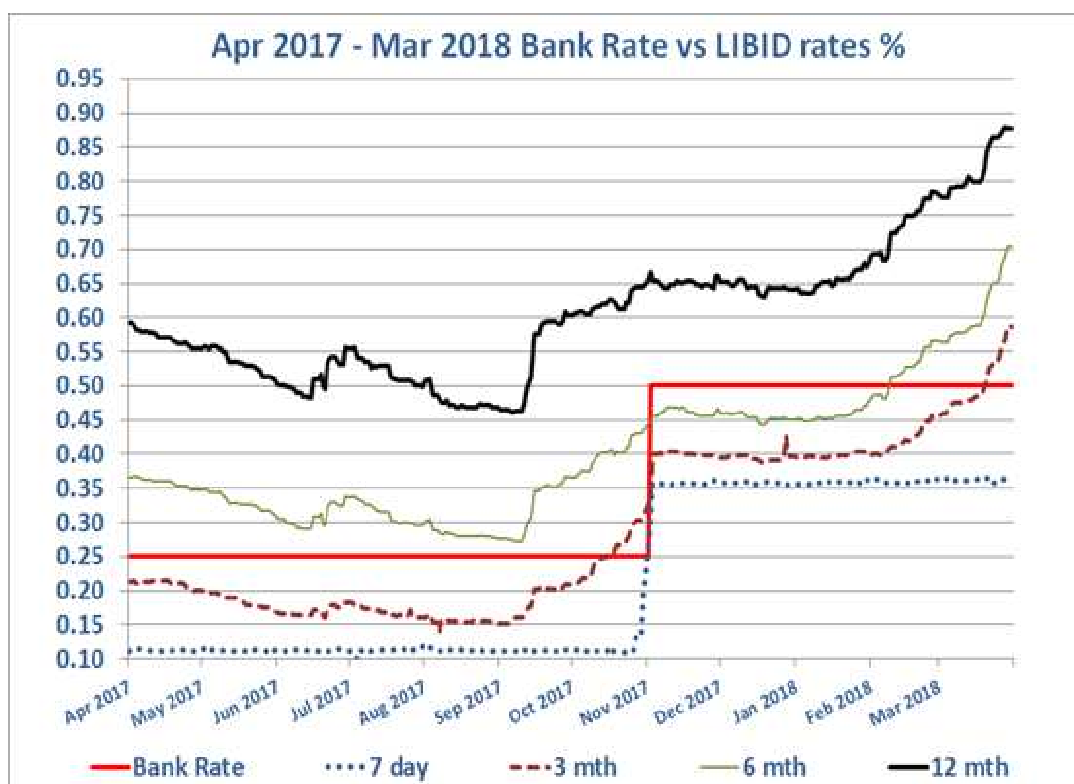
Summary of debt transactions:-

The average interest rate payable on external debt increased from 3.32% to 3.47%. The average life of debt within the loan portfolio lengthened from 24.15 years to 26.45 years.

8. Investment Rates in 2017/18

Investment 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 2.11.17 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 28.2.18.



Money market fund rates started the year between 0.23%-0.48%, trending at base and sub-base rate levels throughout the year.

9. Investment Outturn 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 7 February 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 maintained an average balance of £84.7 million of internally managed funds. The internally managed funds earned an average rate of return of 0.64%. The comparable performance indicator is the average 6-month LIBID un-compounded rate, which was 0.40%.

10. Performance Measurement

One of the key requirements in the Code is the formal introduction of performance measurement relating to investments, debt and capital financing activities.

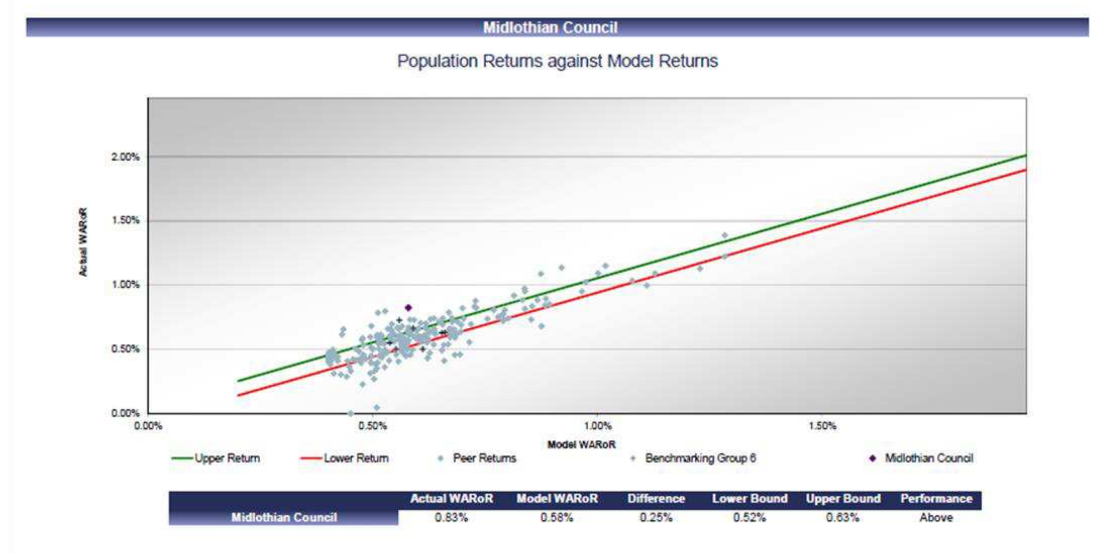
Loans Fund Rate

Combining the interest paid (earned) on external debt (investments) with charges for premiums written off and internal interest allowed into an average Loans Fund Rate, Midlothian's result of 3.24% for 2016/17 was the lowest Loans Fund Rate amongst all mainland authorities in Scotland (see Appendix 1).

The comparative Loans Fund Rate for 2017/18, of 3.08%, is once again expected to be one of the lowest when benchmarked against all mainland authorities in Scotland (note that at present, these benchmark figures are not yet available).

Investment Benchmarking

The Council participates in the Scottish Investment Benchmarking Group set up by its Treasury Management Consultants, Capita. This service provided by Capita provides benchmarking data to authorities for reporting and monitoring purposes, by measuring the security, liquidity and yield within an individual authority portfolio. Based on the Council's investments as at 31 March 2018, the Weighted Average Rate of Return (WARoR) on investments of 0.75% against other authorities is shown in the graph below:-



	Actual WARoR	Model WARoR	Difference	Lower Bound	Upper Bound	Performance
Midlothian Council	0.83%	0.58%	0.25%	0.52%	0.63%	Above

** Models for 30 June 2017, 30 September 2017 and 31 December 2017 are attached as Appendix 3.*

As can be seen from the above graph, Midlothian is performing above the Capita model benchmarks (red to green lines), and is achieving one of the

highest Weighted Average Rates of Return (WARoR) for the Weighted Average Credit Risk held, not only amongst peer Councils within the Benchmarking Group but also amongst the population of authorities across the UK.

Debt Performance

Whilst investment performance criteria have been well developed and universally accepted, debt performance indicators continue to be a more problematic area with the traditional average portfolio rate of interest acting as the main guide. In this respect, the relevant figures for Midlothian are incorporated in the table in Section 3.

11. Conclusion

The Council's overall cost of borrowing continues to benefit significantly from proactive Treasury Management activity.

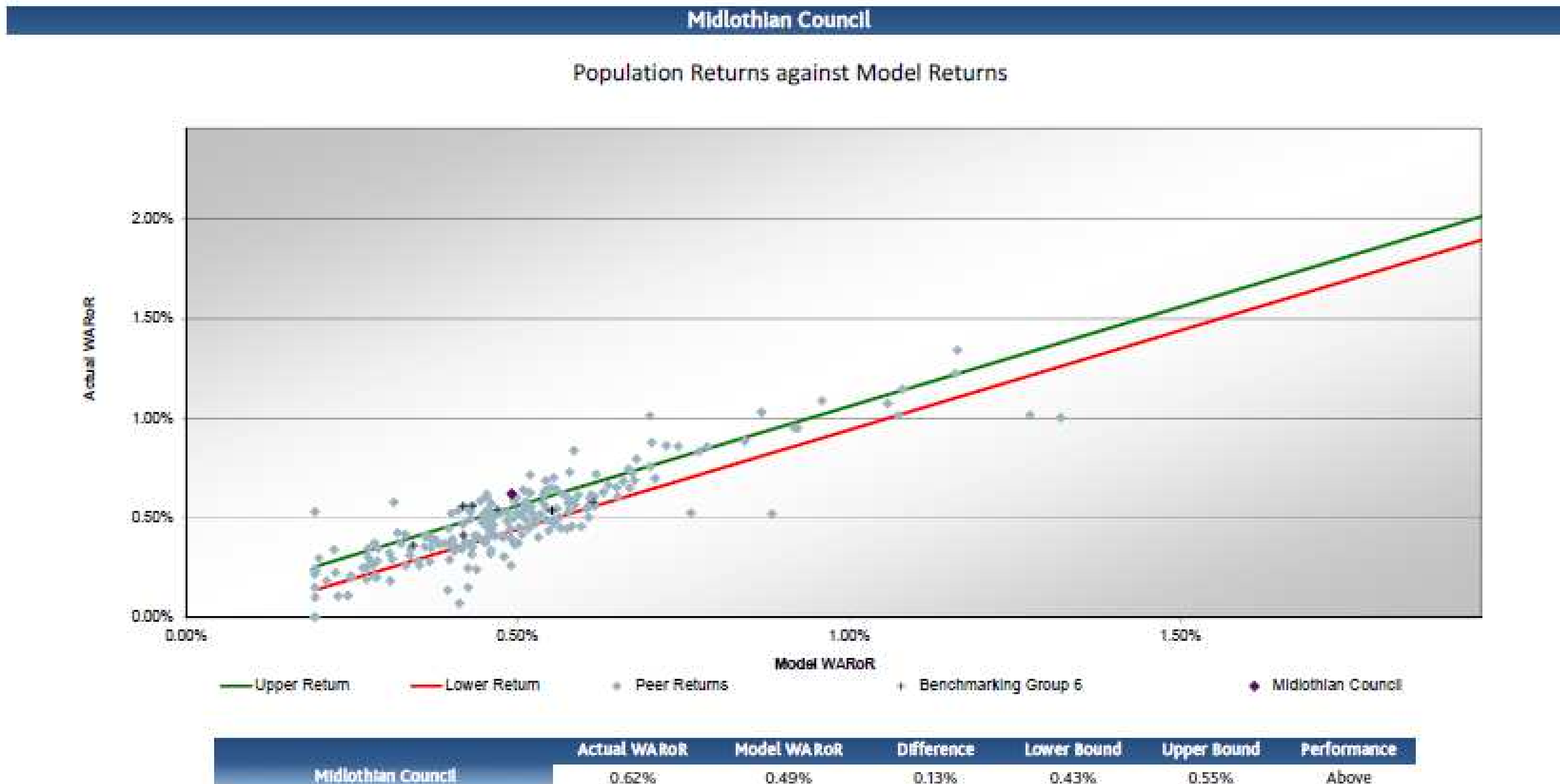
The cost of long term borrowing has been maintained by taking up opportunities to borrow from the PWLB at low interest rates whilst advantage has also been taken of the low rates available for temporary borrowing.

A better than average return on investments has been achieved for the tenth consecutive year and Midlothian continues to perform above the Sector model benchmarks and is achieving one of the highest Weighted Average Rates of Return (WARoR) for the Weighted Average Credit Risk held, not only amongst peer Councils within the Benchmarking Group but also amongst the population of authorities across the UK.

Overall Midlothian's Loans Fund Rate of 3.08% for the year is expected to be one of the lowest when benchmarked against all mainland Authorities in Scotland.

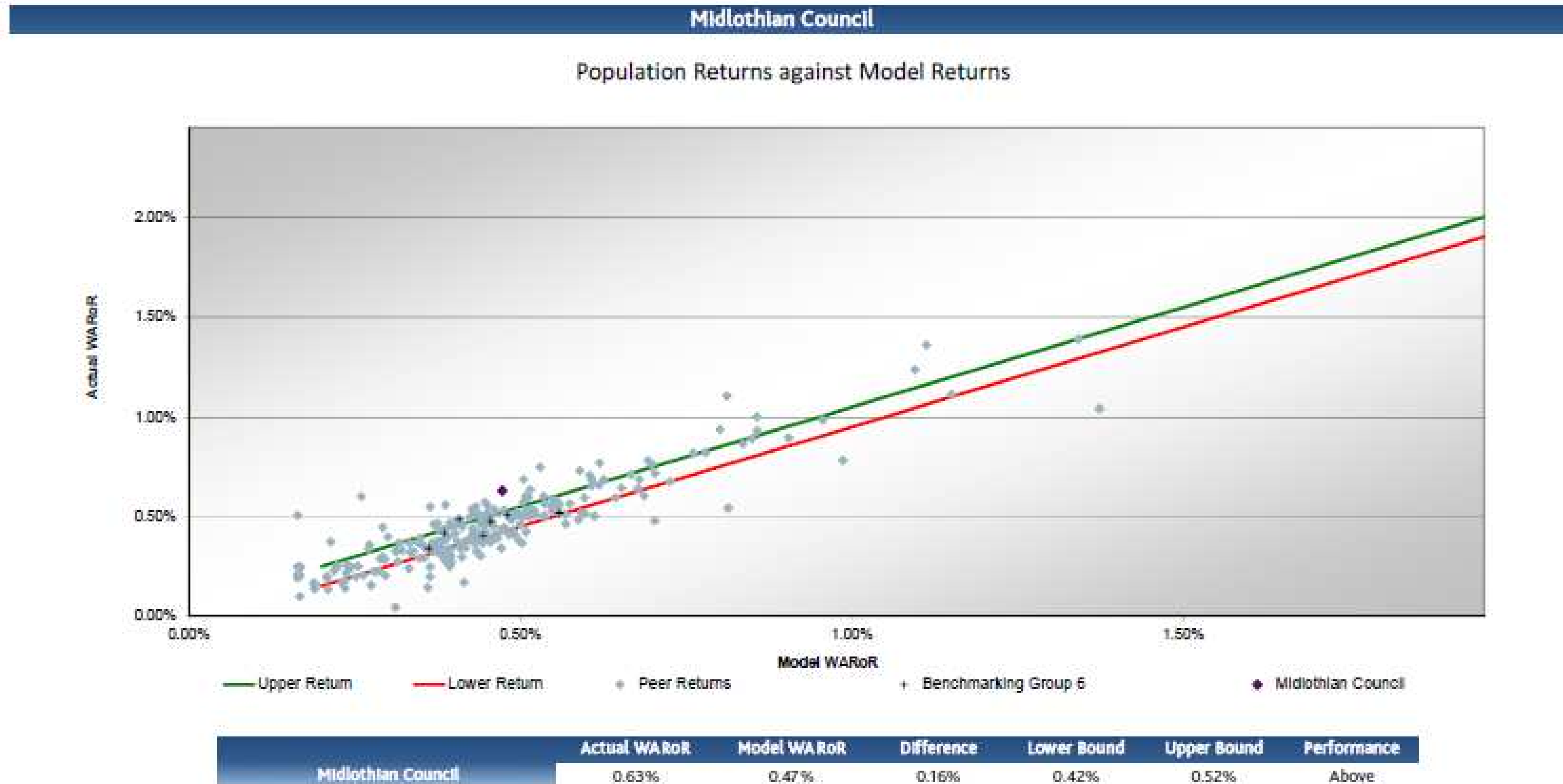
Appendix 3

Midlothian Council Investment Portfolio return as at 30 June 2017



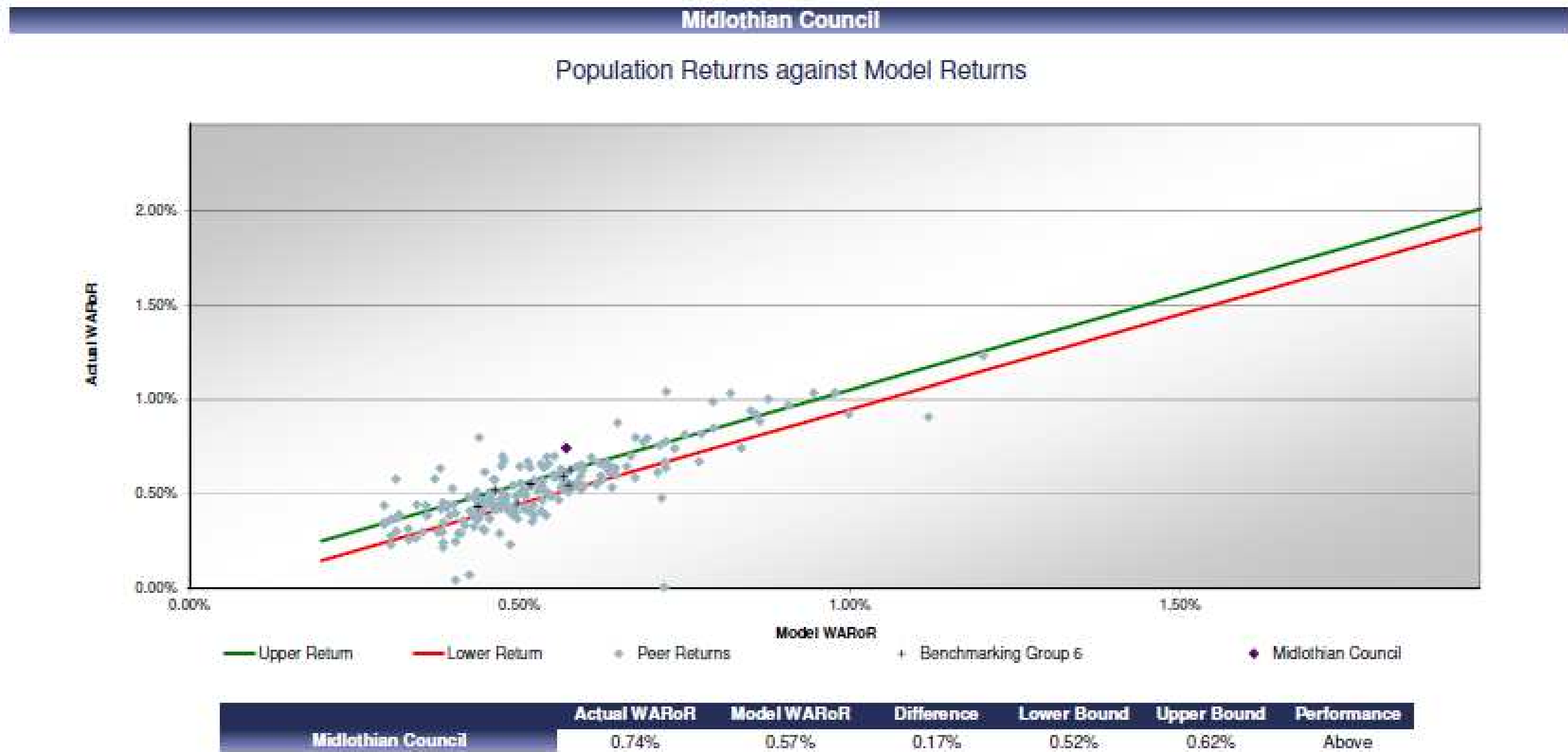
	Actual WA RoR	Model WA RoR	Difference	Lower Bound	Upper Bound	Performance
Midlothian Council	0.62%	0.49%	0.13%	0.43%	0.55%	Above

Midlothian Council Investment Portfolio return as at 30 September 2017



	Actual WA RoR	Model WA RoR	Difference	Lower Bound	Upper Bound	Performance
Midlothian Council	0.63%	0.47%	0.16%	0.42%	0.52%	Above

Midlothian Council Investment Portfolio return as at 31 December 2017



	Actual WARoR	Model WARoR	Difference	Lower Bound	Upper Bound	Performance
Midlothian Council	0.74%	0.57%	0.17%	0.52%	0.62%	Above