Midlothian

Council
Tuesday 25 June 2019

Annual Treasury Management Report 2018/19

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 2018/19 and the year-end position.

2. Background

The main points arising from treasury activity in 2018/19 were:

- Total new long term borrowing taken in the year amounted to £10.700 million, comprising the following:-
    - One £10.000 million Equal Instalment of Principal loan sourced from Deutsche Pfandbriefbank, drawn on 15 November 2018 following loan execution and hedging of interest rate in February 2016.
    - One £0.700 million Equal Instalment of Principal loan sourced from Salix, drawn in two phases on 19 December 2018 (£0.560 million) and 04 March 2019 (£0.140 million), at a rate of 0.00% and offered to the Council to part finance the Non-Domestic Energy Efficiency Framework project;

- Total long term borrowing maturing in the year amounted to £10.452 million, comprising the following:-
    - One £10.000 million Maturity Loan with PWLB matured on 15 November 2018 (original tenor 8.5 years at an interest rate of 3.41%), refinanced by the EIP loan from Deutsche Pfandbriefbank;
    - £0.034 million of PWLB Annuities of various tenors and interest rates;
    - £0.357 million of Annuity loan from Deutsche Pfandbriefbank;
    - £0.061 million of Salix interest free loans.

- No new long term investments were placed;

- The average rate of interest paid on external debt was 3.64% in 2018/19, up from 3.37% in 2017/18 and reflecting the lower average carrying value of temporary loans during the year compared to 2017/18;

- The average rate of return on investments was 0.86% in 2018/19, exceeding the benchmark of 0.79% for the fifteenth year in succession;

- The pooled internal loans fund rate for General Fund and HRA increased marginally from 3.08% in 2017/18 (2nd lowest in mainland Scotland – see Appendix 1) to 3.12% in 2018/19, 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 3.96%, this would have generated loan charges in 2018/19 of £18.8 million. The Council's actual 2018/19 loan charges for General Services and HRA were £16.5 million, representing a cash saving (compared to the Scotland average) of £2.3 million in 2018/19;

- 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 charged to the General Fund provides support to the Council's medium term financial strategy and capital plans. This methodology was retained in 2018/19.

- No debt rescheduling was undertaken during 2018/19.

A detailed report "*Annual Treasury Management Review 2018/19*" on the activity during 2018/19 is attached as Appendix 2.

The Treasury Portfolio at the start and end of the financial year is shown in Tables 1 and 2 below.

Table 1: Loan Portfolio at 1 April 2018 and 31 March 2019

Loan Type	**Principal Outstanding £000's**	**Principal Outstanding £000's**	**Movement £000's**
PWLB Annuity	708	674	-34
PWLB Maturity	197,224	187,224	-10,000
LOBO	20,000	20,000	0
Forward Starting Loans	9,821	19,464	+9,643
Temporary Market Loans	13,000	9,000	-4,000
Salix Loans	277	916	+639
Total Loans	**241,031**	**237,279**	**-3,752**

Table 2: Investment Portfolio 1 April 2018 and 31 March 2019

Investment Type	**Principal Outstanding £000's**	**Principal Outstanding £000's**	**Movement £000's**
Bank Call Accounts	0	0	0
Money Market Funds	8,026	9,767	+1,741
Bank Notice Accounts	49,985	49,985	0
Other Local Authorities	15,000	15,000	0
Total Investments	**73,011**	**74,752**	**+1,741**

3. Other Issues

As recommended by the Code, this report will be considered by Audit Committee on 24 June 2019 and Council will be updated verbally on the outcome of the Audit Committee consideration.

4. Report Implications

4.1. 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 2018/19 are reported in the Financial Monitoring 2018/19 – General Fund Revenue report elsewhere on today's agenda and reflected in the draft Capital Strategy.

4.2. 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.

4.3. 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.

5. 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.

6. Recommendations

It is recommended that the Council:-

a) Note the Treasury Management Annual Report for 2018/19;

Date 13 June 2019

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 2018/19
Appendix 3: Investment Benchmarking Analysis 2018/19

Appendix 1:-

Loans Fund Pooled Rate Comparison 2017/18

Authority	2017/18
West Dunbartonshire	3.070%
Midlothian	**3.078%**
Dumfries & Galloway	3.090%
Perth & Kinross	3.247%
East Lothian	3.340%
Aberdeenshire	3.510%
Inverclyde	3.600%
Fife	3.630%
North Lanarkshire	3.660%
Falkirk	3.790%
East Dunbartonshire	3.830%
South Lanarkshire	3.850%
East Renfrewshire	3.860%
Dundee City	3.887%
Scottish Borders	4.010%
Moray	4.010%
Highland	4.010%
West Lothian	4.048%
South Ayrshire	4.090%
Argyll & Bute	4.095%
North Ayrshire	4.177%
Stirling	4.207%
Glasgow City	4.230%
Renfrewshire	4.340%
Angus	4.400%
East Ayrshire	4.700%
Aberdeen City	4.957%
Clackmannanshire	5.060%
Edinburgh City	5.120%

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 2018/19

Midlothian Council
June 2019

Contents

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 2018/19. 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 2018/19 the minimum reporting requirements were that the full Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 13/02/2018);
- a mid-year, (minimum), treasury update report (Council 13/02/2018);
- an annual review following the end of the year describing the activity compared to the strategy, (this report);

The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is, therefore, important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

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 Audit Committee before they are reported to the full Council.

1. The Council's Capital Expenditure and Financing 2018/19

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			
	2017/18 Actual £000	**2018/19 Budget £000**	**2018/19 Actual £000**
General Fund			
Capital Expenditure	16,984	36,076	18,209
Available Funding	13,106	24,050	18,045
Borrowing Required	**3,878**	**12,026**	**164**
HRA			
Capital Expenditure	10,571	40,785	14,718
Available Funding	4,989	5,071	11,086
Borrowing Required	**5,582**	**35,714**	**3,632**
General Fund and HRA			
Capital Expenditure	27,555	76,861	32,927
Available Funding	18,095	29,121	29,131
Borrowing Required	**9,460**	**47,740**	**3,796**

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 2018/19 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-18	2018/19	31-Mar-19
CFR:	Actual	Budget	Actual
	£000	£000	£000
Opening balance	**£ 278,783**	**£ 285,875**	**£ 280,511**
Add Borrowing Required	£ 9,460	£ 47,740	£ 3,797
Less scheduled debt amortisation	£ (7,969)	£ (8,419)	£ (9,429)
Closing balance	**£ 280,274**	**£ 325,196**	**£ 274,879**

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 (2017/18) plus the estimates of any additional capital financing requirement for the current (2018/19) and next three 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 2018/19. 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-18	2018/19	31-Mar-19
	Actual	Budget	Actual
	£000	£000	£000
Gross Borrowing	£ 241,032	£ 290,770	£ 237,279
CFR	£ 280,274	£ 325,196	£ 274,879

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	
	2018/19
Authorised limit - borrowing	£482,021
Operational boundary - borrowing	£325,196
Maximum gross borrowing position	£248,652
Average gross borrowing position	£234,727

3. Treasury Position as at 31 March 2019

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 2018/19 the Council's treasury (excluding borrowing by PFI and finance leases) position was as follows:

Table 5: Treasury Position

	31 March 2018 Principal	Rate/ Return	Average Life (Yrs)	31 March 2019 Principal	Rate/ Return	Average Life (Yrs)
Debt						
Fixed Rate Debt						
PWLB	£ 197,933	3.74%	26.87	£ 187,899	3.75%	27.27
Market	£ 28,099	1.92%	20.19	£ 34,380	2.32%	23.20
Total Fixed Rate Debt	**£ 226,032**	**3.51%**	**26.03958**	**£ 222,279**	**3.53%**	**26.64**
Variable Rate Debt						
PWLB	£ -	n/a	n/a	£ -	n/a	n/a
Market	£ 15,000	4.63%	32.71	£ 15,000	4.63%	31.71
Total Variable Rate Debt	**£ 15,000**	**4.63%**	**32.71**	**£ 15,000**	**4.63%**	**32.71**
Total debt/gross borrowing	**£ 241,032**	**3.47%**	**26.4547**	**£ 237,279**	**3.47%**	**27.02**
CFR	**£ 280,274**			**£ 274,879**		
Over/ (under) borrowing	**£ (39,242)**			**£ (37,600)**		
Investments						
Fixed Rate Investments						
In House	£ 15,000	0.79%	2.00	£ 15,000	1.70%	1.0000
With Managers	£ -	n/a	n/a	£ -	n/a	n/a
Total Fixed Rate Investments	**£ 15,000**	**0.79%**	**2.00**	**£ 15,000**	**1.70%**	**1.00**
Variable Rate Investments						
In House	£ 58,011	0.69%	0.42	£ 59,751	0.96%	0.41
With Managers	£ -	n/a	n/a	£ -	n/a	n/a
Total Variable Rate Investments	**£ 58,011**	**0.69%**	**0.42**	**£ 59,751**	**0.96%**	**0.41**
Total Investments	**£ 73,011**	**0.71%**	**0.74**	**£ 74,751**	**1.11%**	**0.53**
Net Borrowing	**£ 168,021**			**£ 162,528**		

The maturity structure of the debt portfolio was as follows:

Table 6: Maturity Structure of Debt Portfolio								
	31-Mar-18		2018/19			31-Mar-19		
	Actual		Original Limits			Actual		
	£000	%	%			£000		%
Under 12 months	£ 23,034	10%	0%	to	50%	£	18,263	8%
12 months to 2 years	£ 8,437	4%	0%	to	50%	£	9,266	4%
2 years to 5 years	£ 9,956	4%	0%	to	50%	£	3,827	2%
5 years to 10 years	£ 1,609	1%	0%	to	50%	£	5,509	2%
10 years to 20 years	£ 55,590	23%	0%	to	50%	£	62,653	26%
20 years to 30 years	£ 9,821	4%	0%	to	50%	£	15,179	6%
30 years to 40 years	£ 85,535	36%	0%	to	50%	£	75,534	32%
40 years to 50 years	£ 42,049	18%	0%	to	50%	£	42,048	18%
50 years and above	£ 5,000	2%	0%	to	50%	£	5,000	2%
Total	**£ 241,031**	**102%**				**£**	**237,279**	**100%**

The maturity structure of the investment portfolio was as follows:

Table 7: Maturity Structure of Investment Portfolio		
	31-Mar-18	31-Mar-19
	£000	£000
Investments		
Under 1 Year	£ 58,011	£ 74,751
Over 1 Year	£ 15,000	£ -
Total	**£ 73,011**	**£ 74,751**

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-18		2018/19			31-Mar-19	
	Actual		Original Limits			Actual	
	£000	%	%			£000	%
Fixed Interest Rate Exposure	£226,032	94%	0%	to	100%	£ 222,279	92%
Variable Interest Rate Exposure	£ 15,000	6%	0%	to	30%	£ 15,000	6%
Total	**£ 241,032**	**100%**				**£ 237,279**	**98%**

4. The Strategy for 2018/19

During 2018-19, 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 & ISS therefore monitored interest rates in financial markets and adopted a pragmatic strategy to avoid taking new long term borrowings based on the Council's capital plans seeing significant rephasing from 2018/19 to 2019/20 and the expectation that longer term interest rates would not increase significantly through 2019/20.

Interest rate forecasts expected only gradual rises in medium and longer term fixed borrowing rates during 2018/19 and the two subsequent financial years. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period.

Link Asset Services Interest Rate View 2.1.18													
	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate	0.50%	0.50%	0.50%	0.50%	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%
5yr PWLB rate	1.60%	1.60%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.10%	2.10%	2.20%	2.30%	2.30%
10yr PWLB rate	2.20%	2.30%	2.40%	2.40%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%
25yr PWLB rate	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB rate	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%

Investment returns remained low during 2018/19. The expectation for interest rates within the treasury management strategy for 2018/19 was that Bank Rate would rise from 0.50% to 0.75%. At the start of 2018-19, and after UK GDP growth had proved disappointingly weak in the first few months of 2018, the expectation for the timing of this increase was pushed back from May to August 2018. Investment interest rates were therefore on a gently rising trend in the first half of the year after April, in anticipation that the MPC would raise Bank Rate in August. This duly happened at the MPC meeting on 2 August 2018. During this period, investments were, therefore, kept shorter term in anticipation that rates would be higher later in the year.

It was not expected that the MPC would raise Bank Rate again during 2018-19 after August in view of the fact that the UK was entering into a time of major uncertainty with Brexit due in March 2019. Value was therefore sought by placing longer term investments after 2 August where cash balances were sufficient to allow this.

Investment rates were little changed during August to October but rose sharply after the MPC meeting of 1 November was unexpectedly hawkish about their perception of building inflationary pressures, particularly from rising wages. However, weak GDP growth data after December, plus increasing concerns generated by Brexit, resulted in investment rates falling back again.

Continued uncertainty in the aftermath of the 2008 financial crisis has 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.

Investment returns remained low during 2018/19. The expectation for interest rates within the treasury management strategy for 2018/19 was that Bank Rate would rise from 0.50% to 0.75%. At the start of 2018-19, and after UK GDP growth had proved disappointingly weak in the first few months of 2018, the expectation for the timing of this increase was pushed back from May to August 2018. Investment interest rates were therefore on a gently rising trend in the first half of the year after April, in anticipation that the MPC would raise Bank Rate in August. This duly happened at the MPC meeting on 2 August 2018.

It was not expected that the MPC would raise Bank Rate again during 2018-19 after August in view of the fact that the UK was entering into a time of major uncertainty with Brexit due in March 2019.

Investment rates were little changed during August to October but rose sharply after the MPC meeting of 1 November was unexpectedly hawkish about their perception of building inflationary pressures, particularly from rising wages. However, weak GDP growth data after December, plus increasing concerns generated by Brexit, resulted in investment rates falling back again.

Continued uncertainty in the aftermath of the 2008 financial crisis has 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.

5. The Economy and Interest Rates

UK. After weak economic growth of only 0.2% in quarter one of 2018, growth picked up to 0.4% in quarter 2 and to a particularly strong 0.7% in quarter 3, before cooling off to 0.2% in the final quarter. Given all the uncertainties over Brexit, this weak growth in the final quarter was as to be expected. However, some recovery in the rate of growth is expected going forward. The annual growth in Q4 came in at 1.4% y/y confirming that the UK was the third fastest growing country in the G7 in quarter 4.

After the Monetary Policy Committee raised Bank Rate from 0.5% to 0.75% in August 2018, it is little surprise that they have abstained from any further increases since then. We are unlikely to see any further action from the MPC until the uncertainties over Brexit clear. If there were a disorderly exit, it is likely that Bank Rate would be cut to support growth. Nevertheless, the MPC has been having increasing concerns over the trend in wage inflation which peaked at a new post financial crisis high of 3.5%, (excluding bonuses), in the three months to December before falling only marginally to 3.4% in the three months to January. British employers ramped up their hiring at the fastest pace in more than three years in the three months to January as the country's labour market defied the broader weakness in the overall economy as Brexit approached. The number of people in work surged by 222,000, helping to push down the unemployment rate to 3.9 percent, its lowest rate since 1975. Correspondingly, the total level of vacancies has risen to new highs.

As for CPI inflation itself, this has been on a falling trend since peaking at 3.1% in November 2017, reaching a new low of 1.8% in January 2019 before rising marginally to 1.9% in February. However, in the February 2019 Bank of England Inflation Report, the latest forecast for inflation over both the two and three year time horizons remained marginally above the MPC’s target of 2%.

The rise in wage inflation and fall in CPI inflation is good news for consumers as their spending power is improving in this scenario as the difference between the two figures is now around 1.5%, i.e. a real terms increase. Given the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months.

Brexit. The Conservative minority government has so far, (8.4.19), been unable to muster a majority in the Commons over its Brexit deal. The EU has set a deadline of April 12 for the House of Commons to propose what form of Brexit it would support. If another form of Brexit, other than the proposed deal, does get a majority by April 12, then it is likely there will need to be a long delay to Brexit to allow time for negotiations with the EU. It appears unlikely that there would be a Commons majority which would support a disorderly Brexit or revoking article 50, (cancelling Brexit). There would also need to be a long delay if there is no majority for any form of Brexit. If that were to happen, then it increases the chances of a general election in 2019; this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

USA. President Trump's massive easing of fiscal policy in 2018 fuelled a (temporary) boost in consumption in 2018 which generated an upturn in the strong rate of growth; this rose from 2.2%, (annualised rate) in quarter 1 of 2018 to 4.2% in quarter 2, 3.5% in quarter 3 and then back to 2.2% in quarter 4. The annual rate came in at 2.9% for 2018, just below President Trump's aim for 3% growth. The strong growth in employment numbers has fed through to an upturn in wage inflation which hit 3.4% in February, a decade high point. However, CPI inflation overall fell to 1.5% in February, a two and a half year low, and looks to be likely to stay around that number in 2019 i.e. below the Fed's target of 2%. The Fed increased rates another 0.25% in December to between 2.25% and 2.50%, this being the fourth increase in 2018 and the ninth in the upward swing cycle. However, the Fed now appears to be edging towards a change of direction and admitting there may be a need to switch to taking action to cut rates over the next two years. Financial markets are now predicting two cuts of 25 bps by the end of 2020.

EUROZONE. The European Central Bank (ECB) provided massive monetary stimulus in 2016 and 2017 to encourage growth in the EZ and that produced strong annual growth in 2017 of 2.3%. However, since then the ECB has been reducing its monetary stimulus measures and growth has been weakening - to 0.4% in quarters 1 and 2 of 2018, and then slowed further to 0.2% in quarters 3 and 4; it is likely to be only 0.1 - 0.2% in quarter 1 of 2019. The annual rate of growth for 2018 was 1.8% but is expected to fall to possibly around half that rate in 2019. The ECB completely ended its programme of quantitative easing purchases of debt in December 2018, which means that the central banks in the US, UK and EU have all ended the phase of post financial crisis expansion of liquidity supporting world financial markets by purchases of debt. However, the downturn in growth, together with inflation falling well under the upper limit of its target range of 0 to 2%, (but it aims to keep it near to 2%), prompted the ECB to take new measures to stimulate growth. With its refinancing rate already at 0.0% and the deposit rate at -0.4%, it has probably reached the limit of cutting rates. At its March 2019 meeting it said that it expects to leave interest rates at their present levels "at least through the end of 2019", but that is of little help to boosting growth in the near term. Consequently, it also announced a third round of TLTROs; this provides banks with cheap borrowing every three months from September 2019 until March 2021 which means that, although they will have only a two-year maturity, the Bank is making funds available until 2023, two years later than under its previous policy. As with the last round, the new TLTROs will include an incentive to encourage bank lending, and they will be capped at 30% of a bank's eligible loans.

CHINA. Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; 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.

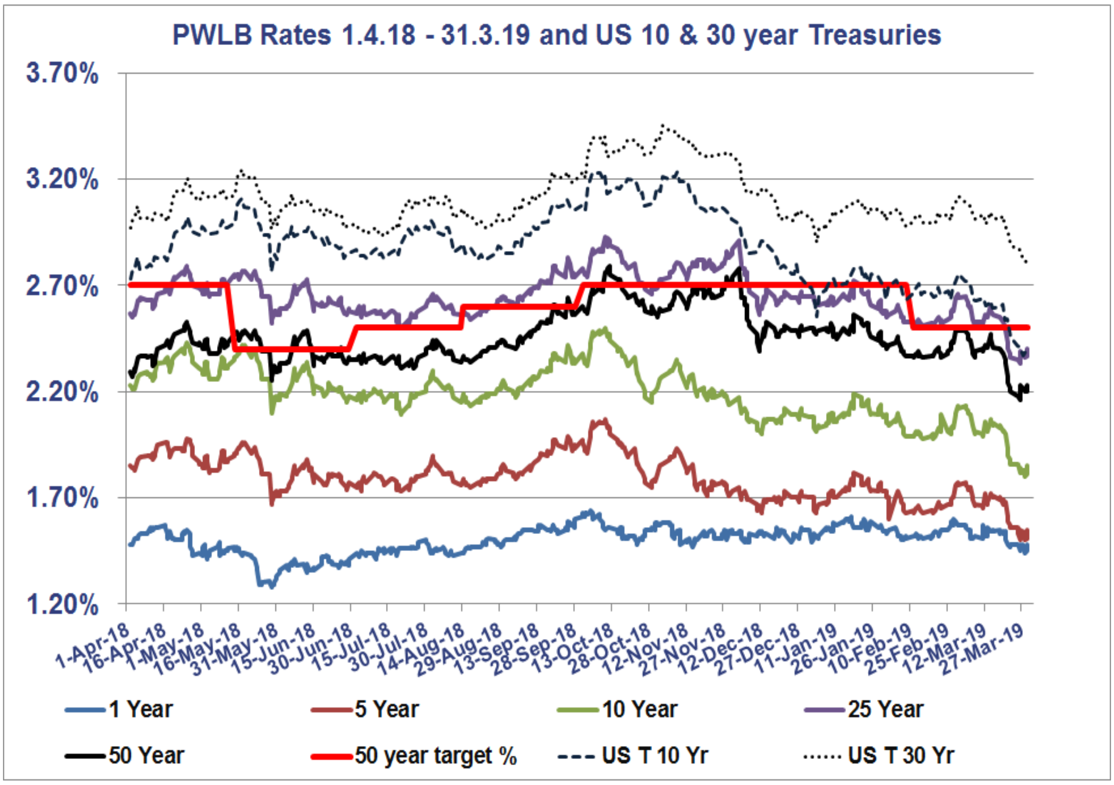
JAPAN - has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

WORLD GROWTH. Equity markets are currently concerned about the synchronised general weakening of growth in the major economies of the world: they fear there could even be a recession looming up in the US, though this fear is probably overdone.

6. Borrowing Rates in 2018/19

Since PWLB rates peaked during October 2018, most PWLB rates have been on a general downward trend, though longer term rates did spike upwards again during December, and, (apart from the 1 year rate), reached lows for the year at the end of March. There was a significant level of correlation between movements in US Treasury yields and UK gilt yields -which determine PWLB rates. The Fed in America increased the Fed Rate four times in 2018, making nine increases in all in this cycle, to reach 2.25% – 2.50% in December. However, it had been giving forward guidance that rates could go up to nearly 3.50%. These rate increases and guidance caused Treasury yields to also move up. However financial markets considered by December 2018, that the Fed had gone too far, and discounted its expectations of further increases. Since then, the Fed has also come round to the view that there are probably going to be no more increases in this cycle. The issue now is how many cuts in the Fed Rate there will be and how soon, in order to support economic growth in the US. But weak growth now also looks to be the outlook for China and the EU so this will mean that world growth as a whole will be weak. Treasury yields have therefore fallen sharply during 2019 and gilt yields / PWLB rates have also fallen.

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.



	1 Year	5 Year	10 Year	25 Year	50 Year
02/04/2018	1.48%	1.85%	2.23%	2.57%	2.29%
29/03/2019	1.48%	1.55%	1.85%	2.40%	2.23%
Low	1.28%	1.50%	1.80%	2.33%	2.16%
Date	29/05/2018	26/03/2019	28/03/2019	26/03/2019	26/03/2019
High	1.64%	2.07%	2.50%	2.93%	2.79%
Date	04/10/2018	10/10/2018	10/10/2018	10/10/2018	12/10/2018
Average	1.50%	1.80%	2.20%	2.66%	2.47%

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 2018/19

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 2018/19						
Lender	**Date Taken**	**Principal £000's**	**Interest Rate**	**Fixed/ Variable**	**Maturity Date**	**Term (Yrs)**
Deutsche Pfandbriefbank	15 Nov 2018	£ 10,000	2.73%	Fixed	15 May 2044	25.50
Salix	19 Dec 2018	£ 560	0.00%	Fixed	01 Apr 2024	5.30
Salix	14 Mar 2019	£ 140	0.00%	Fixed	01 Apr 2024	5.05
Market	Various	£ 82,280	0.33%-0.81%	Variable interest rate	Various	0.09-0.18
Total		**£ 92,980**				

Market loans of £82.280 million reflect an average carrying value of £7.685 million of Temporary Borrowing at an average rate of 0.49%. This compares against a budget assumption of new short-term market borrowing of £39.0 million at an average interest rate of 0.53%.

Medium-long term borrowing of £10.700 million taken at a weighted average rate of 2.55% compares with a budget assumption of new borrowing of £23.576 million at an average interest rate of 2.86%.

Maturing Debt:-

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

Table 10: Maturing Debt in Financial Year 2018/19						
Lender	**Date Repaid**	**Principal £000's**	**Interest Rate**	**Fixed/ Variable**	**Date Originally Taken**	**Original Term (Yrs)**
PWLB	Various (Annuities)	£ 34	8.72%	Fixed	Various	59.75
PWLB	15 Nov 2018	£ 10,000	3.41%	Fixed	28 May 2010	8.50
Salix	Various	£ 61	0.00%	Fixed	Various	7-8 years
Deutsche Pfandbriefbank	Various	£ 357	2.63%	Fixed	29 Jun 2017	28.00
Market	Various	£ 86,280	0.33%-0.68%	Variable interest rate	Various	0.09-0.18
Total		**£ 96,732**				

Rescheduling:-

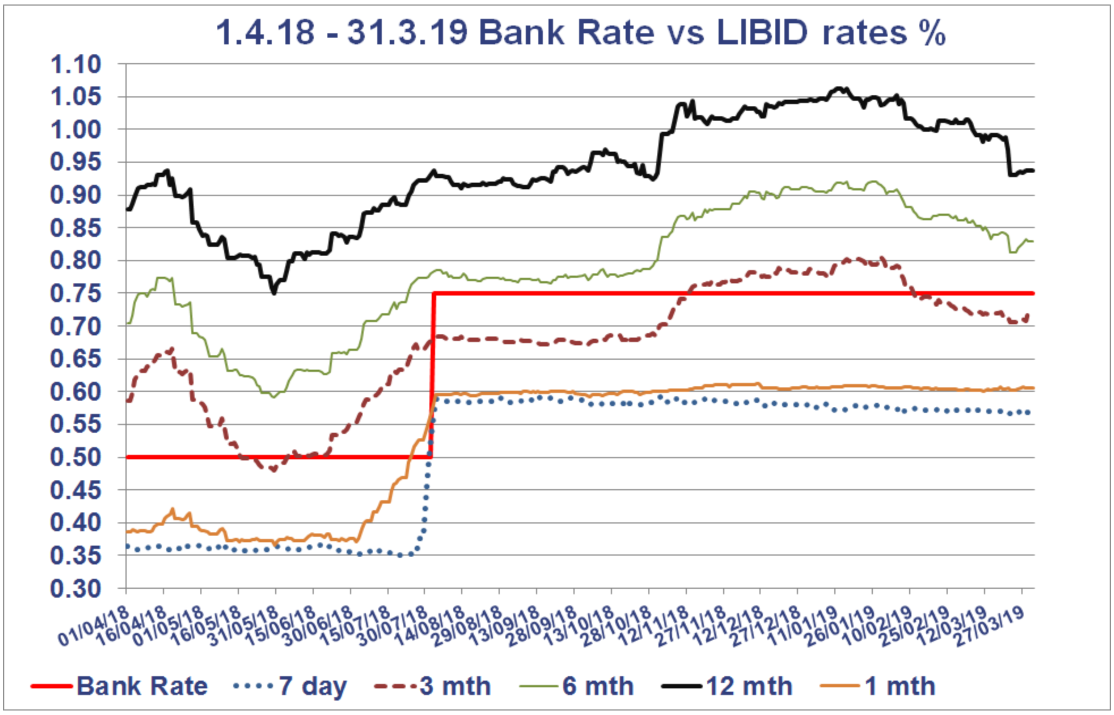
No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

Summary of debt transactions:-

The average interest rate payable on external debt increased marginally from 3.57% at the start of 2018/19 to 3.59% at the end of 2018/19. The average life of debt within the loan portfolio lengthened marginally from 26.45 years to 26.96 years.

8. Investment Rates in 2018/19

Money market fund rates started the year between 0.41%-0.46%, trending at base rate levels throughout the year, and mirroring the increase of 0.25% in Base Rate in August before finishing the year at just north of base rate (0.75%-0.78%).



9. Investment Outturn for 2018/19

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 13 February 2018. 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 £77.0 million of internally managed funds. The internally managed funds earned an average rate of return of 0.86%. The comparable performance indicator is the average 6-month LIBID un-compounded rate, which was 0.79%.

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.

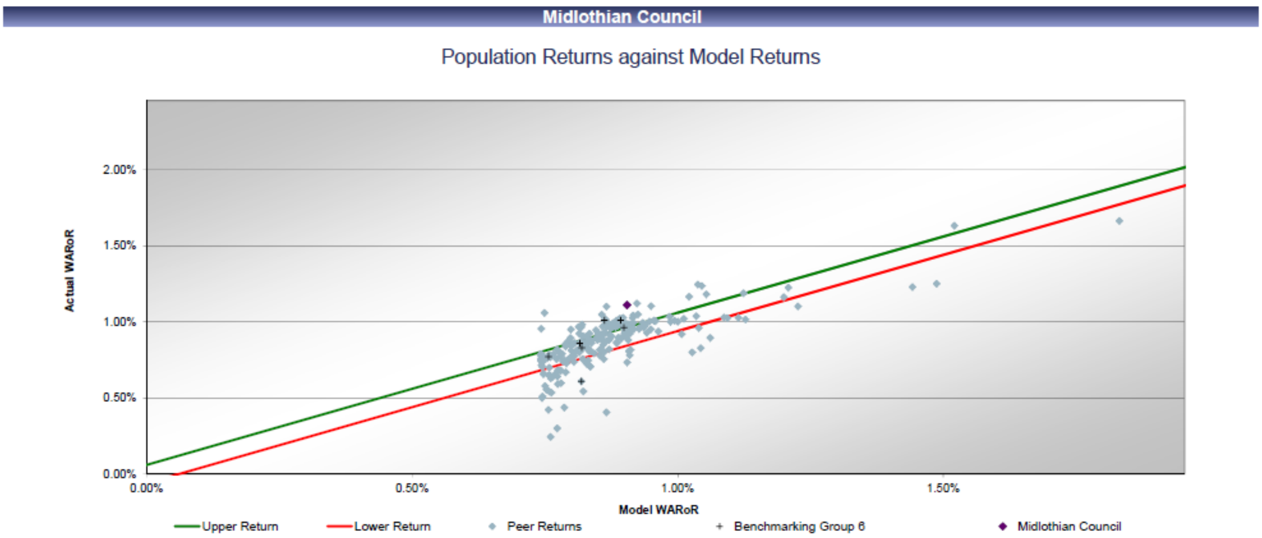
<u>Loans Fund Rate</u>

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 3.08% for 2017/18 was the second lowest Loans Fund Rate amongst all mainland authorities in Scotland (see Appendix 1).

The comparative Loans Fund Rate for 2018/19, of 3.12%, 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).

<u>Investment Benchmarking</u>

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 1.11% against other authorities is shown in the graph below:-



Midlothian Council	Actual WARoR	Model WARoR	Difference	Lower Bound	Upper Bound	Performance
	1.11%	0.90%	0.21%	0.84%	0.96%	Above

** Models for 30 June 2018, 30 September 2018 and 31 December 2018 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.

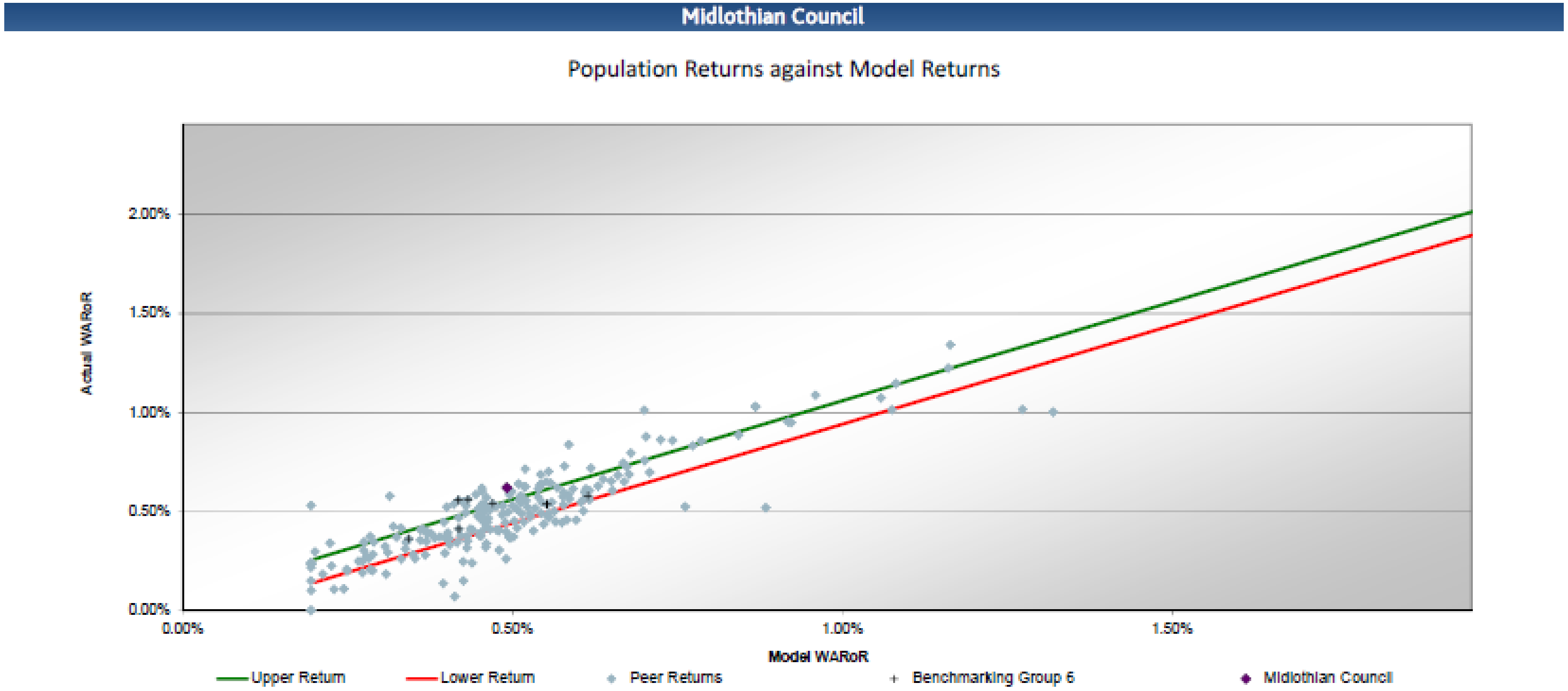
The cost of long term borrowing has been maintained by taking up opportunities to borrow from the PWLB at low interest rates whilst advantage has also been taken of the low rates available for temporary borrowing.

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.

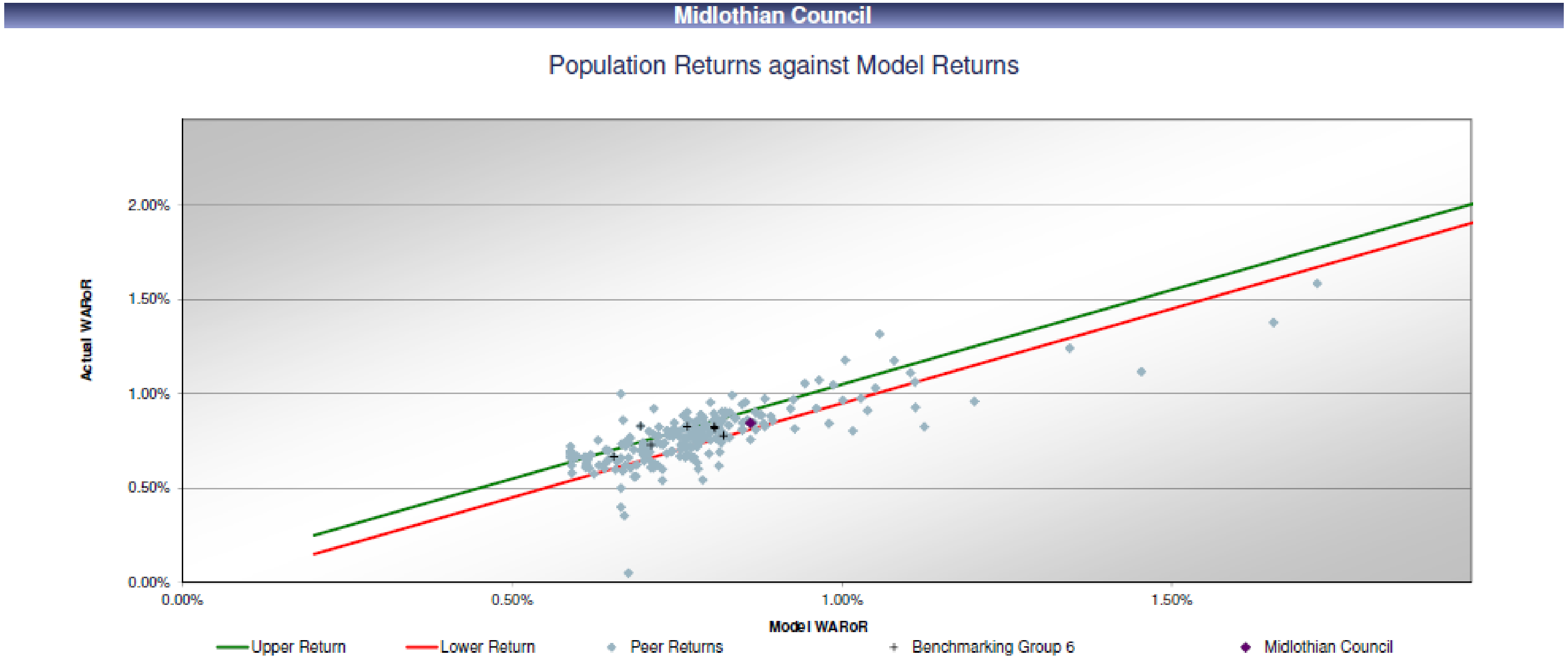
Appendix 3

Midlothian Council Investment Portfolio return as at 30 June 2018



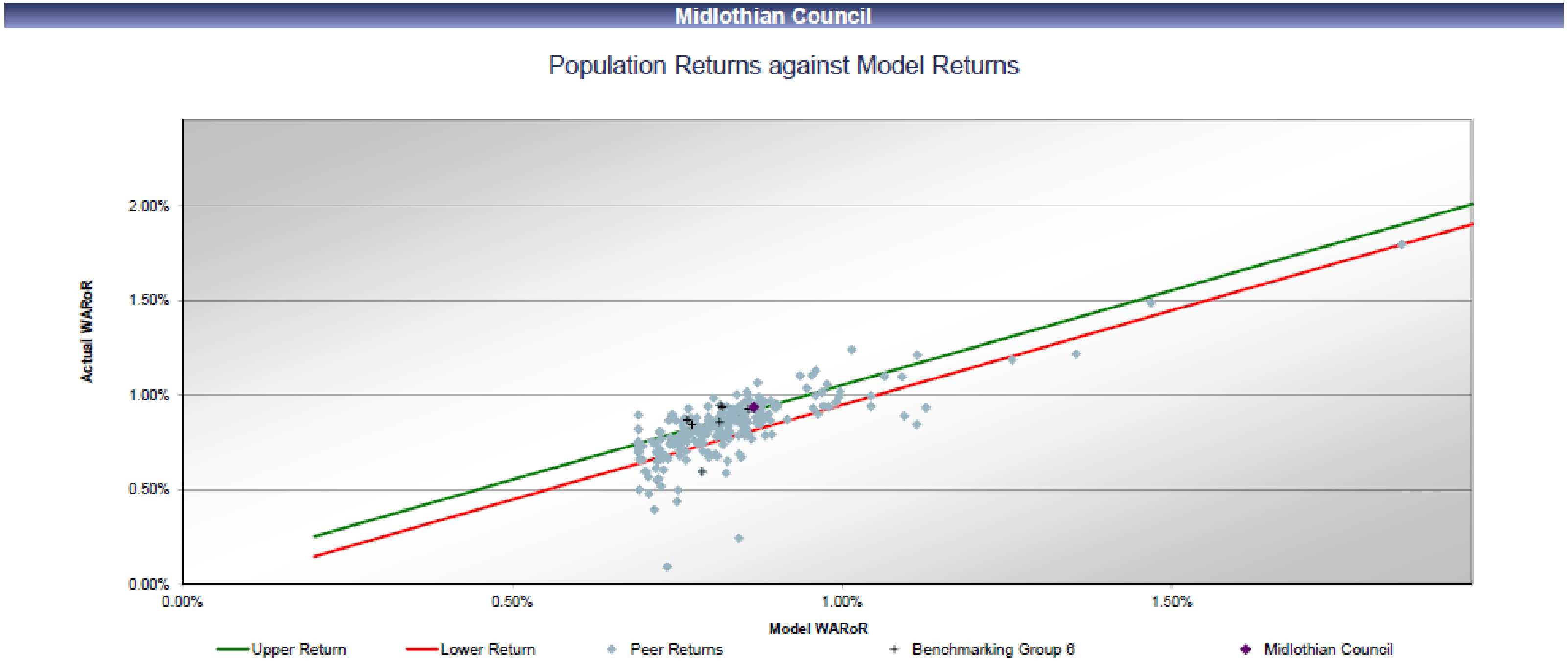
	Actual WARoR	Model WARoR	Difference	Lower Bound	Upper Bound	Performance
Midlothian Council	0.62%	0.49%	0.13%	0.43%	0.55%	Above

Midlothian Council Investment Portfolio return as at 30 September 2018



	Actual WARoR	Model WARoR	Difference	Lower Bound	Upper Bound	Performance
Midlothian Council	0.85%	0.86%	-0.02%	0.81%	0.91%	Inline

Midlothian Council Investment Portfolio return as at 31 December 2018



Midlothian Council	Actual WARoR	Model WARoR	Difference	Lower Bound	Upper Bound	Performance
	0.94%	0.87%	0.07%	0.81%	0.92%	Above