Midlothian Council
Tuesday 16 December 2014
Item No 21

Treasury Management Mid-Year Review Report 2014/15

Report by Gary Fairley, Head of Finance and Human Resources

1 Purpose of Report

The purpose of this report is to inform members of the Treasury Management activity undertaken during the first half of 2014/15, the forecast activity for the second half of 2014/15, and update the Prudential Indicators for 2014/15.

2 Background

Council, on 04 February 2014, approved the Treasury Management and Annual Investment Strategy Statement for the financial year 2014/15.

3. Treasury Activity during first half of 2014/15

A detailed report on the activity during 2014/15, to 30 November 2014, is enclosed as Appendix 1. The main points arising from treasury activity during the first half of 2014/15 were:

- The average interest rate earned on external investments was 0.86%, exceeding the benchmark rate of 0.50%. The comparator figure for the half-year in 2013/14 was 1.46% (and full year equivalent 1.23%), with the year-on-year drop reflective of the challenging economic and investment environment;
- There was no long-term borrowing sourced in the year to 30 November 2014;
- No debt rescheduling has been undertaken during the period;
- The Council has taken the opportunity to place two fixed term deposits, both with Lloyds Banking Group, totalling £30m. This allows the Council to both cash back its reserves and add value to its portfolio with minimal risk through the utilisation of a secure counterparty with UK Government support;

The Council's loan and investment portfolio as at 30 November 2014 is shown in the table overleaf (position at 31 March 2014 also shown for comparison):-

Loan Type	31 March 14			30 November 14		
	Principal Outstanding		Weighted Average Rate	Principal Outstanding		Weighted Average Rate
	£000's		%	£000's		%
PWLB Annuity	£	818	8.89%	£	794	8.90%
PWLB Maturity	£	187,175	3.86%	£	167,175	4.03%
LOBO	£	20,000	4.51%	£	20,000	4.51%
Temporary Market	£	18,000	0.38%	£	39,500	0.34%
Other Loans	£	-	n/a	£	255	0.00%
Total Loans	**£**	**225,993**	**3.65%**	**£**	**227,724**	**3.44%**
Underlying Borrowing Requirement*	**£**	**253,283**		**£**	**251,810**	
Internal Borrowing	**£**	**27,290**		**£**	**24,086**	

Investment Type	31 March 14			30 November 14		
	Principal Outstanding		Weighted Average Rate	Principal Outstanding		Weighted Average Rate
	£000's		%	£000's		%
Bank Call Accounts	£	3,950	0.40%	£	2	0.39%
Money Market Funds	£	9,123	0.44%	£	15,511	0.48%
Bank Notice Accounts	£	26,053	1.10%	£	0	0.30%
Bank Fixed Term Deposits	£	-	n/a	£	30,000	1.02%
Total Investments	**£**	**39,127**	**0.88%**	**£**	**45,513**	**0.83%**

* *The Underlying Borrowing Requirement is the Capital Financing Requirement excluding the PPP Liabilities*

4. Expected Treasury Activity during second half of 2014/15

- Council, on 23 September 2014, approved the inclusion of a subscription of subordinated debt to the Newbattle Centre SPV. The list of Permitted Investments attached as Appendix 2 has been updated accordingly;
- Through discussions with the Council's Treasury Management Advisers, Capita, officers have identified the opportunity to invest in Certificates of Deposits. These instruments are similar in structure to Fixed Deposits i.e. the deposit is placed with a deposit taking institution (mainly banks) for a fixed term. Where they differ from Fixed Deposits is the ability to trade these instruments in a secondary market. As with Fixed Deposits, it is intended to only invest in high credit rated counterparties, to minimise the risk to the security of any funds placed. A certificate of deposit typically earns interest at rates only marginally lower than Fixed Deposits, reflecting the ability of these instruments to be traded in the secondary market. The inclusion of Certificates of Deposit as an allowable instrument in the Council's Permitted Investments would add value to the Council's overall investment portfolio;
- The Council has a significant borrowing requirement over the short-medium term, with a particular cluster of loans maturing in the period 2.5 years to 6 years from now, all of which will require to be refinanced. The opportunity has arisen to forward deal these loans.

This would involve the Council entering into a legal commitment over the course of the next month, to draw down these loans at specific intervals 2.5 years to 6 years from now, broadly matching the maturity profile of existing loans within this period. This would allow the Council to draw down these loans at interest rates that are significantly less than current market projections, and eliminate any cost of carry. Officers will ensure that loans are drawn to match the existing maturity profile 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 of £352.6m proposed in Section 5 below;

- Given the capital expenditure forecasts reported elsewhere on today's agenda, there is no requirement to source long-term borrowing to fund capital expenditure that is anticipated to be incurred in the second half of 2014/15. However, consideration will continue to be given as to whether borrowing now (for capital expenditure in 2015/16) to secure historically low PWLB rates offer value compared with forward interest rate projections.

Taken all of the above into account, the expected loan and investment portfolio at 31 March 2015 is shown in the table below:-

Loan Type	31 March 15	
	Principal Outstanding	Weighted Average Rate
	£000's	%
PWLB Annuity	£ 794	8.89%
PWLB Maturity	£ 167,175	3.86%
LOBO	£ 20,000	4.51%
Temporary Market	£ 50,000	0.30%
Other Loans	£ 236	n/a
Total Loans	**£ 238,206**	**3.18%**
Underlying Borrowing Requirement*	**£ 268,552**	
Internal Borrowing	**£ 30,346**	
Investment Type	**31 March 15**	
	Principal Outstanding	**Weighted Average Rate**
	£000's	**%**
Bank Call Accounts	£ -	0.50%
Money Market Funds	£ 5,000	0.48%
Bank Notice Accounts	£ -	0.30%
Bank Fixed Term Deposits	£ 30,000	n/a
Certificate of Deposit	£ 10,000	0.89%
Total Investments	**£ 45,000**	**0.93%**

** The Underlying Borrowing Requirement is the Capital Financing Requirement excluding the PPP Liabilities*

5. Prudential Indicators 2014/15

The following prudential indicators have been refreshed from those reported to Council on 04 February 2014 in the original Treasury Management and Annual Investment Strategy Statement 2014/15, based on the actual outturn for 2013/14 and the Council's Capital Plans for 2014/15, 2015/16 and 2016/17:-

Prudential Indicators 2014/15	2014/15 Original Estimate £000's	2014/15 Revised Estimate £000's
Capital Expenditure	£ 31,170	£ 37,039
Required Borrowing	£ 18,422	£ 22,333
Capital Financing Requirement*	£ 331,215	£ 324,732
Underlying Borrowing Requirement**	£ 273,915	£ 268,552
External Debt - Borrowing	£ 225,617	£ 237,969
Authorised Limit - Borrowing***	£ 336,676	£ 352,610
Operational Boundary - Borrowing***	£ 319,842	£ 334,980

** Includes on balance sheet PPP schemes.*

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**** The Authorised Limit for Borrowing has been calculated by taking the maximum value of the CFR over the current financial year and the next 2 financial years (2014/15 to 2016/17), 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).*

The **Capital Financing Requirement (CFR)** denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing), with the balance of external and internal borrowing generally driven by market conditions. 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. This was recommended to be £336.7m in the Treasury Strategy report presented to Council on 04 February 2014 and subsequently agreed by Council.

Rather than restrict borrowing in the remainder of 2014/15 to:-

- the expected Underlying Borrowing Requirement for this year (£268.6m); or

- the Authorised Limit for Borrowing of £336.7m approved by Council on 05 February 2014;

it is proposed that permission be granted to borrow up to the authorised limit for borrowing of £352.6m as at 31 March 2017 (as shown in the table below), if market conditions supported 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 minimized and that the maturity structure of all debt is sufficiently robust to ensure that the CFR at 31 March 2017 remains achievable.

Item	**£000's**
CFR – General Services (31 March 2017)	131,097
CFR – HRA (31 March 2017)	201,763
Unrealised Capital Receipts & Developer Contributions 2014/15	4,387
Forecast level of Capital Receipts & Developer Contributions 2015/16-2017/18	15,363
Proposed Authorised Limit	**352,610**

6 Report Implications

6.1 Resource

Expenditure from Treasury Management activity i.e. loan charges, is reported in quarterly financial positions to Council, with Quarter 2 monitoring reflected in the Financial Monitoring report elsewhere on today's agend**a.**

6.2 Risk

As the Council follows the requirements of the CIPFA Code of Practice for Treasury Management, and the Prudential Code, there is a reduced level of risks involved in Treasury Management activities. Those risks that do exist are further controlled through written Treasury Management Practices which define the responsibilities of all staff involved and these have recently been reviewed and updated.

6.3 Single Midlothian Plan and Business Transformation

Themes addresses 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 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 Capita 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 IT Issues

There are no IT issues arising from this report.

7 Summary

Treasury Management activity during the year to 30 November 2014 has been effective in maximising investment income and minimising borrowing costs within the parameters set by the strategy for the year.

The list of Permitted Investments has been updated to include the subscription of Subordinated Debt approved by Council on 23 September 2014, and the proposal to add Certificates of Deposit as outlined in Section 4.

The Council has a significant cluster of loans maturing over the short-medium term, and an opportunity has arisen to forward deal to book these loans now, with the drawdown of these loans deferred until broadly the point of need. Officers will ensure that any loans drawn through this mechanism will offer value to the Council's loan portfolio and are matched to existing loan maturities as closely as possible.

8 Recommendations

It is recommended that Council

a) Note that the Financial Services team has achieved a better than benchmark return on investments for the year to 30 November 2014;

b) Note the report and the treasury activity undertaken in the first-half of the year, and the expected activity during the second-half of the year;
c) Approve the revisions to the Prudential Indicators in Section 5 of this report;
d) Approve the revised list of Permitted Investments included as Appendix 2 to this report.

09 December 2014

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Appendix 1

Treasury Management
Mid-year Review Report 2014/15

1 Background

The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

Accordingly treasury management is defined as:-

> *"The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."*

2 Introduction

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management was adopted by the Council on 23 March 2010, with a revised 2011 edition noted by Council in the Treasury Management and Investment Strategy 2012/13 report on 28 February 2012.

The primary requirements of the revised Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.

2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.

3. Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy - for the year ahead; a **Mid-year Review Report (this report)** and an Annual Report (stewardship report) covering activities during the current/ previous year.

4. Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

5. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is Audit Committee.

This mid-year report has been prepared in compliance with CIPFA's Code of Practice, and covers the following:

- An economic update for the 2014/15 financial year to 30 September 2013; (Section 3);
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy (Section 4);
- The Council's capital expenditure (prudential) indicators (Section 5);
- A review of the Council's investment portfolio for 2014/15 (Section 6);
- A review of the Council's borrowing strategy for 2014/15 (Section 7);
- A review of any debt rescheduling undertaken during 2014/15 (Section 8).

3 Economic update

3.1 Economic performance to date

3.1.1 U.K.

After strong UK GDP quarterly growth of 0.7%, 0.8% and 0.7% in quarters 2, 3 and 4 respectively in 2013, (2013 annual rate 2.7%), and 0.7% in Q1, 0.9% in Q2 and a first estimate of 0.7% in Q3 2014 (annual rate 3.1% in Q3), it appears very likely that strong growth will continue through 2014 and into 2015 as forward surveys for the services and construction sectors, are very encouraging and business investment is also strongly recovering. The manufacturing sector has also been encouraging though the latest figures indicate a weakening in the future trend rate of growth. However, for this recovery to become more balanced and sustainable in the longer term, the recovery needs to move away from dependence on consumer expenditure and the housing market to exporting, and particularly of manufactured goods, both of which need to substantially improve on their recent lacklustre performance. This overall strong growth has resulted in unemployment falling much faster through the initial threshold of 7%, set by the Monetary Policy Committee (MPC) last August, before it said it would consider any increases in Bank Rate. The MPC has, therefore, subsequently broadened its forward guidance by adopting five qualitative principles and looking at a much wider range of about eighteen indicators in order to form a view on how much slack there is in the economy and how quickly slack is being used up. The MPC is particularly concerned that the current squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back above the level of inflation in order to ensure that the recovery will be sustainable. There also needs to be a major improvement in labour productivity, which has languished at dismal levels since 2008, to support increases in pay rates. Most economic forecasters are expecting growth to peak in 2014 and then to ease off a little, though still remaining strong, in 2015 and 2016. Unemployment is therefore expected to keep on its downward trend and this is likely to eventually feed through into a return to significant increases in pay rates at some point during the next three years. However, just how much those future increases in pay rates will counteract the depressive effect of increases in Bank Rate on consumer confidence, the rate of growth in consumer expenditure and the buoyancy of the housing market, are areas that will need to be kept under regular review.

Also encouraging has been the sharp fall in inflation (CPI), reaching 1.2% in September, the lowest rate since 2009. Forward indications are that inflation is likely to fall further in 2014 to possibly 1%. Overall, markets are expecting that the MPC will be cautious in raising Bank Rate as it will want to protect heavily indebted consumers from too early an increase in Bank Rate at a time when inflationary pressures are also weak. A first increase in Bank Rate is therefore expected in Q2 2015 and they expect increases after that to be at a slow pace to lower levels than prevailed before 2008 as increases in Bank Rate will have a much bigger effect on heavily indebted consumers than they did before 2008.

The return to strong growth has also helped lower forecasts for the increase in Government debt by £73bn over the next five years, as announced in the 2013 Autumn Statement, and by an additional £24bn, as announced in the March 2014

Budget - which also forecast a return to a significant budget surplus, (of £5bn), in 2018-19. However, monthly public sector deficit figures have disappointed so far in 2014/15.

3.1.2 U.S.

In September, the Federal Reserve continued with its monthly $10bn reductions in asset purchases, which started in December 2013. Asset purchases have now fallen from $85bn to $15bn and are expected to stop on 29th October 2014, providing the economic outlook remains strong. First quarter GDP figures for the US were depressed by exceptionally bad winter weather, but growth rebounded very strongly in Q2 to 4.6% (annualised).

The U.S. faces similar debt problems to those of the UK, but thanks to reasonable growth, cuts in government expenditure and tax rises, the annual government deficit has been halved from its peak without appearing to do too much damage to growth, although the weak labour force participation rate remains a matter of key concern for the Federal Reserve when considering the amount of slack in the economy and monetary policy decisions.

3.1.3 Eurozone

The Eurozone is facing an increasing threat from weak or negative growth and from deflation. In September, the inflation rate fell further, to reach a low of 0.3%. However, this is an average for all EZ countries and includes some countries with negative rates of inflation. Accordingly, the ECB took some rather limited action in June to loosen monetary policy in order to promote growth. In September it took further action to cut its benchmark rate to only 0.05%, its deposit rate to -0.2% and to start a programme of purchases of corporate debt. However, it has not embarked yet on full quantitative easing (purchase of sovereign debt).

Concern in financial markets for the Eurozone subsided considerably during 2013. However, sovereign debt difficulties have not gone away and major issues could return in respect of any countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy, (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise for some countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed.

3.1.3 China and Japan

Japan is causing considerable concern as the increase in sales tax in April has suppressed consumer expenditure and growth. In Q2 growth was -1.8% q/q and -7.1% over the previous year. The Government is hoping that this is a temporary blip.

As for China, Government action in 2014 to stimulate the economy appeared to be putting the target of 7.5% growth within achievable reach but recent data has raised fresh concerns. There are also major concerns as to the creditworthiness of much bank lending to corporates and local government during the post 2008 credit expansion period and whether the bursting of a bubble in housing prices is drawing nearer.

3.2 Interest rate forecasts

The Council's treasury advisor, Capita Asset Services, has provided the following forecast:

	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank rate	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%	1.75%	2.00%	2.25%	2.50%
5yr PWLB rate	2.50%	2.70%	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.50%	3.50%	3.50%
10yr PWLB rate	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%	4.20%	4.20%	4.30%	4.30%
25yr PWLB rate	3.90%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	5.00%
50yr PWLB rate	3.90%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	5.00%

Capita Asset Services undertook a review of its interest rate forecasts on 24 October. During September and October, a further rise in geopolitical concerns, principally over Ukraine but also over the Middle East, plus fears around Ebola and an accumulation of dismal growth news in most of the ten largest economies of the world and also on the growing risk of deflation in the Eurozone, had sparked a flight from equities into safe havens like gilts and depressed PWLB rates. However, there is much volatility in rates as news ebbs and flows in negative or positive ways. This latest forecast includes a first increase in Bank Rate in quarter 2 of 2015.

Our PWLB forecasts are based around a balance of risks. However, there are potential upside risks, especially for longer term PWLB rates, as follows: -

- A further surge in investor confidence that robust world economic growth is firmly expected, causing a flow of funds out of bonds and into equities.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

Downside risks currently include:

- The situation over Ukraine poses a major threat to EZ and world growth if it was to deteriorate into economic warfare between the West and Russia where Russia resorted to using its control over gas supplies to Europe.
- Fears generated by the potential impact of Ebola around the world
- UK strong economic growth is currently mainly dependent on consumer spending and the potentially unsustainable boom in the housing market. The boost from these sources is likely to fade after 2014.
- A weak rebalancing of UK growth to exporting and business investment causing a weakening of overall economic growth beyond 2014.

- Weak growth or recession in the UK’s main trading partner - the EU, inhibiting economic recovery in the UK.
- A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations.
- A resurgence of the Eurozone sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and Eurozone governments to deal with the potential size of the crisis.
- Recapitalisation of European banks requiring more government financial support.
- Lack of support by populaces in Eurozone countries for austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.
- Italy: the political situation has improved but it remains to be seen whether the new government is able to deliver the austerity programme required and a programme of overdue reforms. Italy has the third highest government debt mountain in the world.
- France: after being elected on an anti austerity platform, President Hollande has embraced a €50bn programme of public sector cuts over the next three years. However, there could be major obstacles in implementing this programme. Major overdue reforms of employment practices and an increase in competiveness are also urgently required to lift the economy out of stagnation.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- Heightened political risks in the Middle East and East Asia could trigger safe haven flows back into bonds.
- There are also increasing concerns at the reluctance of western central banks to raise interest rates significantly for some years, plus the huge QE measures which remain in place (and may be added to by the ECB in the near future). This has created potentially unstable flows of liquidity searching for yield and, therefore, heightened the potential for an increase in risks in order to get higher returns. This is a return to a similar environment to the one which led to the 2008 financial crisis.

4 Treasury Management and Annual Investment Strategy Statement update

The Treasury Management & Annual Investment Strategy Statement (TMSS) for 2014/15 was approved by this Council on 4th February 2014.

The following prudential indicators have been refreshed from those reported to Council in the original Treasury Management and Annual Investment Strategy Statement 2014/15 presented to Council on 4th February 2014, based on the actual outturn for 2013/14 and activity during the first 6 months of 2014/15:-

Prudential Indicators 2014/15		
	2014/15 Original Estimate £000's	2014/15 Revised Estimate £000's
Capital Expenditure	£ 31,170	£ 37,039
Required Borrowing	£ 18,422	£ 22,333
Capital Financing Requirement*	£ 331,215	£ 324,732
Underlying Borrowing Requirement**	£ 273,915	£ 268,552
External Debt - Borrowing	£ 225,617	£ 237,969
Authorised Limit - Borrowing***	£ 336,676	£ 352,610
Operational Boundary - Borrowing***	£ 319,842	£ 334,980

** Includes on balance sheet PPP schemes.*

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**** Authorised Limit for Borrowing equates to the maximum expected Underlying Borrowing Requirement over this financial year and the following 2 financial years. Operational Boundary equates to 95% of the Authorised Limit and is the level of borrowing that day-to-day Treasury activity will be focused on to ensure that the Authorised Limit is not breached.*

A breakdown of the Council's investment portfolio is shown in Section 6 of this report. New external borrowing undertaken is identified in Section 7 of this report.

5 The Council's Capital Position (Prudential Indicators)

This part of the report is structured to update:

- The Council's capital expenditure plans;
- How these plans are being financed;
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

5.1 Prudential Indicator for Capital Expenditure

This table shows the revised estimates for capital expenditure and the changes since the original Treasury Strategy was reported to Council on 05 February 2013.

Capital Expenditure			
Service	2014/15 Original Estimate £000's	2014/15 Current Position £000's	2014/15 Revised Estimate £000's
General Services			
Resources	£ 4,812	£ 2,139	£ 9,140
Education, Community & Economy	£ 4,665	£ 1,076	£ 6,137
Health & Social Care	£ 150	£ 79	£ 406
Business Transformation	£ 243	£ 106	£ 1,315
Unallocated to date	£ 5,338	£ -	£ -
Total General Services	**£ 15,208**	**£ 3,400**	**£ 16,998**
Total HRA	**£ 15,962**	**£ 4,122**	**£ 20,041**
Combined Total	**£ 31,170**	**£ 7,522**	**£ 37,039**

Capital Expenditure on:-

- Resources has increased by £4.3m from the original estimate in the Treasury Management & Annual Investment Strategy Statement reported to Council on 4th February 2014, as a result of slippage in expenditure from 2013/14, and the new block budgets for Road Upgrades and Property Upgrades;
- Education has increased by £1.5m as a result of slippage in expenditure from 2013/14 and the inclusion of St. Andrew's, Cornbank and Newtongrange Primary School extension project in the Plan;
- Health & Social Care has increased by £0.3m as a result of slippage in expenditure from 2013/14;
- Business Transformation has increased by £1.1m as a result of Phase II of the EWiM project;
- HRA programme has increased by £4.1m as a result of slippage in expenditure from 2013/14 and the acceleration of the Phase II programme, including Newbyres replacement.

5.2 Changes to the Financing of the Capital Programme

The table below details how the Capital Expenditure in Section 5.1 is to be financed:-

Financing of Capital Expenditure			
	2014/15 Original £000's	2014/15 Current £000's	2014/15 Revised £000's
Total Spend	**£ 31,170**	**£ 7,522**	**£ 37,039**
Financed By:-			
Capital Receipts	£ 1,085	£ 781	£ 1,955
Capital Grants	£ 8,707	£ 4,126	£ 8,669
Capital Reserves	£ -	£ -	£ -
Developer/Other Contributions	£ 2,956	£ 1,145	£ 4,082
Total Financing	**£ 12,748**	**£ 6,052**	**£ 14,706**
Borrowing Required to finance Capital Plans	**£ 18,422**	**£ 1,470**	**£ 22,333**

Total expected financing has increased by £2.0m from £12.7m to £14.7m as a result of an increase in the projected level of house sales, and a realignment of Developer Contributions to match revised expenditure profiles.

The borrowing element of the table above increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although both (i) the required borrowing, and (ii) the CFR, will be reduced in part by the in-year revenue charges for the repayment of debt (the Principal Debt Repayments).

This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

5.3 Changes to the Prudential Indicators for the Capital Financing Requirement, External Debt and the Operational Boundary

The table shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period.

Prudential Indicators for CFR and External Debt			
	2014/15 Original Estimate £000's	2014/15 Current Position £000's	2014/15 Revised Estimate £000's
Prudential Indicator - Capital Financing Requirement (CFR)			
CFR - General Services	£ 114,451	£ 104,303	£ 108,512
CFR - HRA	£ 159,464	£ 147,930	£ 160,040
CFR - PPP Liability	£ 57,300	£ 56,833	£ 56,180
Total CFR at Year End	**£ 331,215**	**£ 309,066**	**£ 324,732**
Net Movement in CFR	**£ 22,017**	**£ 11,943**	**£ 14,149**
Prudential Indicator - External Debt			
Borrowing	£ 225,617	£ 227,724	£ 237,969
Other Long-Term Liabilities (PPP Liability)	£ 57,300	£ 56,833	£ 56,180
Total Debt at Year End	**£ 282,917**	**£ 284,557**	**£ 294,149**

The original estimate of the CFR for 2014/15, of £331.2m, has reduced by £6.5 million to £324.7m as a result of a reduction in the borrowing requirement arising from the Council's capital plans in 2013/14 and 2014/15, compared with the original forecasts.

5.4 Limits to Borrowing Activity

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2014/15 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

The Head of Finance & Human Resources reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government in Scotland Act 2003.

Authorised Limit for External Debt			
	2014/15 Original Estimate £000's	**2014/15 Current Position £000's**	**2014/15 Revised Estimate £000's**
Authorised Limit			
Borrowing*	£ 336,676	£ 336,676	£ 352,610
Other Long-term Liabilities**	£ 57,300	£ 56,180	£ 56,180
Total	**£ 393,976**	**£ 408,790**	**£ 408,790**

** The Authorised Limit for Borrowing has been calculated by taking the maximum value of the CFR over the current financial year and the next 2 financial years (2014/15 to 2016/17), 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).*
*** Includes on balance sheet PFI schemes.*

Rather than restrict borrowing in the remainder of 2014/15 to:-

- the expected Underlying Borrowing Requirement for this year (£268.6m); or
- the Borrowing Authorised Limit of £336.7m approved by Council on 05/04/14;

it is proposed that permission be granted to borrow up to the authorised limit for borrowing of £352.6m as at 31 March 2017 (as shown in the table below), if market conditions supported 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 minimized and that the maturity structure of all debt is sufficiently robust to ensure that the CFR at 31 March 2017 remains achievable.

6 Investment Portfolio 2014/15

Actual Investments in the half year to date

As at 30 November 2014, the Council held £45.5m of investments (£39.1m as at 31 March 2014) and the investment portfolio yield for the first six months of the year is 0.86% against a benchmark 3 month un-compounded LIBOR rate of 0.50%. Investment returns for the half-year to 30th November 2013 amount to £0.196m.

Investment Type	31 March 14			30 November 14		
	Principal Outstanding		Weighted Average Rate	Principal Outstanding		Weighted Average Rate
	£000's		%	£000's		%
Bank Call Accounts	£	3,950	0.40%	£	2	0.39%
Money Market Funds	£	9,123	0.44%	£	15,511	0.48%
Bank Notice Accounts	£	26,053	1.10%	£	0	0.30%
Bank Fixed Term Deposits	£	-	n/a	£	30,000	1.02%
Total Investments	**£**	**39,127**	**0.88%**	**£**	**45,513**	**0.83%**

The Head of Finance & Integrated Service Support confirms that the approved limits within the Annual Investment Strategy were not breached during the first 8 months of 2014/15.

In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite.

As set out in Section 3, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low, with instant access deposits in line with, or below, the 0.5% Bank Rate and fixed term deposits with a 1 year term yielding c. 1% or below throughout the first half of the year.

Indeed, the introduction of the Funding for Lending scheme has reduced market investment rates even further. The potential for a prolonging of the Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment, investment returns are likely to remain low.

The Council has taken the opportunity to place two fixed term deposits, both with Lloyds Banking Group, totalling £30m. This allows the Council to both cash back its reserves and add value to its portfolio with minimal risk through the utilisation of a secure counterparty with UK Government support.

Projected Investment Activity for the second half of the year

Through discussions with the Council's Treasury Management Advisers, Capita, officers have identified the opportunity to invest in Certificates of Deposits. These instruments are similar in structure to Fixed Deposits i.e. the deposit is placed with a deposit taking institution (mainly banks) for a fixed term. Where they differ from Fixed Deposits is the ability to trade these instruments in a secondary market. As with Fixed Deposits, it is intended to only invest in high credit rated counterparties, to minimise the risk to the security of any funds placed. A certificate of deposit typically earns interest at rates only marginally lower than Fixed Deposits, reflecting the ability of these instruments to be traded in the secondary market. The inclusion of Certificates of Deposit as an allowable instrument in the Council's Permitted Investments would add value to the Council's overall investment portfolio.

The expected investment portfolio as at 31 March 2015 is shown in the table below:-

Investment Type	31 March 15	
	Principal Outstanding	Weighted Average Rate
	£000's	%
Bank Call Accounts	£ -	0.50%
Money Market Funds	£ 5,000	0.48%
Bank Notice Accounts	£ -	0.30%
Bank Fixed Term Deposits	£ 30,000	n/a
Certificate of Deposit	£ 10,000	0.89%
Total Investments	**£ 45,000**	**0.93%**

The Council's budgeted investment return for the full year 2014/15 is £0.226m (representing a 0.77% return on an expected average investment level of £29.2m).

<u>Investment Counterparty criteria</u>

The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function. This uses the Capita Asset Services credit scoring methodology which is a sophisticated methodology incorporating credit ratings from the three main credit rating agencies, credit watches and credit outlooks, CDS spreads and Country sovereign ratings to provide a list of only the most creditworthy counterparties, and for these counterparties, a maximum suggested duration for any one investment.

7 Borrowing

Actual borrowing in the half-year to date

As at 30 November 2014, the Council held £227.7m of external borrowing (£226.0m as at 31 March 2014), as shown in the table below:-

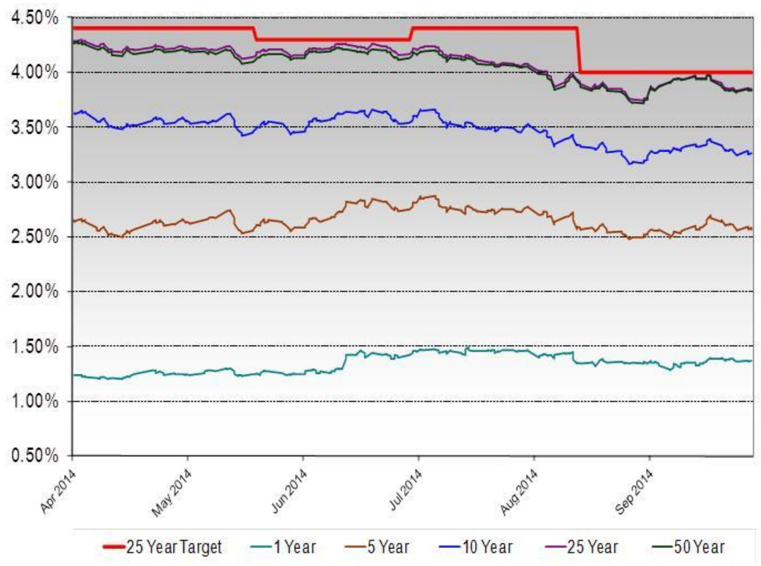
Loan Type	31 March 14		30 November 14	
	Principal Outstanding	Weighted Average Rate	Principal Outstanding	Weighted Average Rate
	£000's	%	£000's	%
PWLB Annuity	£ 818	8.89%	£ 794	8.90%
PWLB Maturity	£ 187,175	3.86%	£ 167,175	4.03%
LOBO	£ 20,000	4.51%	£ 20,000	4.51%
Temporary Market	£ 18,000	0.38%	£ 39,500	0.34%
Other Loans	£ -	n/a	£ 255	0.00%
Total Loans	**£ 225,993**	**3.65%**	**£ 227,724**	**3.44%**
Underlying Borrowing Requirement*	**£ 253,283**		**£ 251,810**	
Internal Borrowing	**£ 27,290**		**£ 24,086**	

** The Underlying Borrowing Requirement is the CFR excluding the PPP Liabilities*

No new long-term borrowing has been undertaken in the financial year to 30 November 2014.

The table in section 7 above shows the Council currently has borrowings of £227.7m, with an Underlying Borrowing Requirement of £251.8m. The Council has therefore utilised £24.1m of cash flow funds in lieu of borrowing. This is a prudent and cost effective approach in the current economic climate but will require ongoing monitoring in the event that upside risk to gilt yields prevails.

The graph below show the movement in PWLB rates for the first six months of the year to 30th September 2014:-



Projected borrowing for the second half of the year

The expected external borrowing portfolio at 31 March 2015 is as shown in the table below:-

Loan Type	31 March 15	
	Principal Outstanding	Weighted Average Rate
	£000's	%
PWLB Annuity	£ 794	8.89%
PWLB Maturity	£ 167,175	3.86%
LOBO	£ 20,000	4.51%
Temporary Market	£ 50,000	0.30%
Other Loans	£ 236	n/a
Total Loans	**£ 238,206**	**3.18%**
Underlying Borrowing Requirement*	**£ 268,552**	
Internal Borrowing	**£ 30,346**	

** The Underlying Borrowing Requirement is the CFR excluding the PPP Liabilities*

The Council's capital financing requirement (CFR) for 2014/15 is £324.7m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions.

The 2014/15 CFR of £324.7m includes the PPP Liability of £56.2m, thereby giving an Underlying Borrowing Requirement of £268.6m.

The Council has a significant borrowing requirement over the short-medium term, with a particular cluster of loans maturing in the period 2.5 years to 6 years from now, all of which will require to be refinanced. The opportunity has arisen to forward deal these loans. This would involve the Council entering into a legal commitment over the course of the next month, to draw down these loans at specific intervals 2.5 years to 6 years from now, broadly matching the maturity profile of existing loans within this period. This would allow the Council to draw down these loans at interest rates that are significantly less than current market projections, and eliminate any cost of carry. Officers will ensure that loans are drawn to match the existing maturity profile 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 of £352.6m proposed in Section 5 below.

Given the capital expenditure forecasts reported elsewhere on today's agenda, there is no requirement to source long-term borrowing to fund capital expenditure that is anticipated to be incurred in the second half of 2014/15. However, consideration will continue to be given as to whether borrowing now (for capital expenditure in 2015/16) to secure historically low PWLB rates offer value compared with forward interest rate projections.

Borrowing in Advance of Need

The Council has not borrowed in advance of need during the first half of 2014/15 and will only borrow in advance in the second half if market conditions dictate that it is prudent to do so.

The Council has a significant borrowing requirement over the short-medium term, with a particular cluster of loans maturing in the period 2.5 years to 6 years from now, all of which will require to be refinanced. The opportunity has arisen to forward deal these loans. This would involve the Council entering into a legal commitment over the course of the next month, to draw down these loans at specific intervals 2.5 years to 6 years from now, broadly matching the maturity profile of existing loans within this period. This would allow the Council to draw down these loans at interest rates that are significantly less than current market projections, and eliminate any cost of carry. Officers will ensure that loans are drawn to match the existing maturity profile 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 of £352.6m proposed in Section 5 below.

8 Debt Rescheduling

Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates and therefore no debt rescheduling was undertaken during the first six months of 2014/15.

Appendix 2 – Permitted Investments

This table is for use by the in house treasury management team.

1.1 Deposits

	Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period
Debt Management Agency Deposit Facility	--	Term	No	**100%**	**6 months**
Term deposits – local authorities	--	Term	No	**100%**	**2 years**
Call accounts – banks and building societies	Green	Instant	No	**100%**	**1 day**
Term deposits / Notice Accounts – banks and building societies	Orange	Term	No	**100%**	**2 years**
Fixed term deposits with variable rate and variable maturities: -Structured deposits	Orange	Term	No	**100%**	**2 years**

1.2 Deposits with counterparties currently in receipt of government support / ownership

	Minimum Credit Criteria	Liquidity risk	Market risk	Max %/£m of total investments	Max. maturity period
UK nationalised banks – Call accounts	Blue	Instant	No	**100%**	**1 day**
UK nationalised banks – Term Deposits / Notice Accounts	Blue	Term	No	**100%**	**2 years**
UK nationalised banks – Fixed term deposits with variable rate and variable maturities: -Structured deposits	Blue	Term	No	**100%**	**2 years**
Non-UK(high sovereign rated country) nationalised banks – Call accounts	Green	Instant	No	**100%**	**1 day**
Non-UK (high sovereign rated country) nationalised banks:- Term Deposits / Notice Accounts	Orange	Term	No	**100%**	**2 years**
Non-UK (high sovereign rated country) nationalised banks:- Fixed term deposits with variable rate and variable maturities: -Structured deposits	Orange	Term	No	**100%**	**2 years**

If forward deposits are made, the forward period plus the deal period equate to the maximum maturity period.

1.3 Collective investment schemes structured as Open Ended Investment Companies (OEICs)

	Minimum Credit Criteria	**Liquidity risk**	**Market risk**	**Max %/£m of total investments**	**Max. maturity period**
Government Liquidity Funds	AAA	Instant	No	**100%**	**1 day**
Money Market Funds	AAA	Instant	No	**100%**	**1 day**

1.4 Securities issued by corporate organisations

	*** Minimum Credit Criteria**	**Liquidity risk**	**Market risk**	**Max % of total investments**	**Max. maturity period**
Certificates of deposit issued by banks and building societies covered by UK Government (explicit) guarantee	Green	Sale T+1	Yes	**100%**	**2 years**
Certificates of deposit issued by banks and building societies	Green	Sale T+1	Yes	**100%**	**2 years**

1.5 Other

	Minimum Credit Criteria	**Liquidity risk**	**Market risk**	**Max %/£m of total investments**	**Max. maturity period**
Local authority mortgage guarantee scheme.	Blue	Term	No	**50%**	**5 years**
Loans to Third Parties	n/a	Term	No	**£25m**	**20 years**
Subordinated Debt Subscription to Newbattle Centre SPV	n/a	Term	No	**£1m**	**27 years**