Agenda Item No. 7

South Ayrshire Council

Report by Head of Finance and ICT to Audit and Governance Panel (Special) of 26 August 2020

Subject: Treasury Management Annual Report 2019/20

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1. Purpose

1.1 The purpose of this report is to present, in line with the requirements of the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management, the annual report of treasury management activities for 2018/19 (as attached at Appendix 1), and seek Members' consideration of its contents.

2. Recommendation

2.1 It is recommended that the Panel:

2.1.1 considers the Annual Treasury Management Report 2019/20, as attached at Appendix 1; and

2.1.2 remits the Annual Treasury Management Report to the next Leadership Panel meeting on 15 September for approval.

3. Background

3.1 The Council is required through regulations issued under the Local Government in Scotland Act 2003 to produce an annual treasury report reviewing treasury management activities and prudential and treasury indicators. 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).

3.2 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.

3.3 The Head of Finance & ICT also confirms that the Council has complied with the requirements under the Code, to give prior scrutiny of treasury management reporting to the Council's Audit and Governance Panel prior to submitting the report to Leadership Panel.

3.4 Treasury management in this context is defined as:

'The management of the local authority's 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.

3.5 Covid-19 – For much of 2019/20 Treasury Management activity operated within normal market conditions and therefore Covid-19 has had a limited impact on out-turn information for the 2019/20 financial year. When the coronavirus outbreak did hit the UK in February/March this had a significant impact on market and economy as a whole. Section 5; The Economy and Interest Rates and Section 6; Borrowing Rates in 2019/20, provides some further analysis and information on how Covid-19 has effected market conditions in the final few weeks of 2019/20 and the likely impact on 2020.

4. Proposals

4.1 The Treasury Management Annual Report for 2019/20 is submitted to the Panel, as Audit and Governance Panel, in accordance with the requirements of the CIPFA Code of Practice on Treasury Management, for consideration and thereafter remit to the Leadership Panel meeting on 15th September for approval.

4.2 ***Executive Summary***

During 2019/20, the Council complied with its legislative and regulatory requirements. The key prudential indicators detailing the impact of capital expenditure activities during the year, with previous year comparators, are shown below.

Actual Prudential and Treasury Indicators	***2018/19 Actual £'000***	***2019/20 Actual £'000***
Capital Expenditure	**53,271**	**61,896**
Total Capital Financing Requirement (including other long term liabilities)	301,593	341,748
PPP and Finance Lease	(80,512)	(102,219)
Underlying Borrowing Requirement	**221,081**	**239,529**
Gross External Debt	224,093	236,163
Under (Over) Borrowed	(3,012)	3,365
Cash/Investments	(61,100)	(51,975)
Net External Debt	**162,993**	**184,188**

4.3 The table above shows that the Council has a slightly under-borrowed position at 31 March 2020 of £3.365m, c 1%. This means the Council has used some internal borrowing from cash/reserves to fund an element of its current capital expenditure requirements. It does not indicate that borrowing for the capital programme has not been under taken; only that internal cash resource has been used as funding, opposed to external borrowing.

4.4 Although this is a prudent position in the current interest rate environment given the cost of external borrowing compared with cash investment rates, the Council's under-borrowed position is only 1.405% of its overall under-lying borrowing requirement and is therefore manageable within the current strategy. The strategy for 2020/21 is expected to maintain a marginal under-borrowed position whilst closely monitoring longer term PWLB and market rates in considering new borrowing.

4.5 Other prudential and treasury indicators are included in Appendix 1 to this report. The Head of Finance and ICT also confirms that any borrowing was only undertaken for capital purpose and the statutory borrowing limit (the authorised limit) was not breached during 2019/20.

4.6 The financial year 2019/20 continued the challenging investment environment of previous years, namely low investment returns.

5. Legal and Procurement Implications

5.1 There are no legal implications arising from this report.

5.2 There are no procurement implications arising from this report.

6. Financial Implications

6.1 General Services

6.1.1 ***Interest on Revenue Balances Held*** – the Council originally budgeted to receive £0.171m in interest income (based on a return of 1.00%) to the General Fund in 2019/20. Interest rates for investment remained low, however with the investment strategy out performing both the budget and benchmark this resulted in an enhanced return.

Investment income to the General Fund out-turned at £0.301m, a surplus of £0.130m. Interest was also received to the Council's Repairs and Renewals Fund and Insurance Fund to the value of £0.018m.

6.1.2 ***Capital Financing Costs*** - the Council originally budgeted £12.260m for financing costs and expenses on debt for 2019/20. This budget consisted of £5.448m in loan principal, £6.633m in interest and £0.179m in expenses. During 2019/20, a pragmatic approach was taken when considering the borrowing requirements to fund capital expenditure. The borrowing strategy during 2019/20 resulted in savings as under-noted:

	Budget £'000	Out-turn £'000	Variance £'000
Principal	5,448	5,526	(78)
Interest	6,633	6,299	334
Expenses	179	206	(27)
Capital Financing costs	**12,260**	**12,031**	**229**
Investment income	**(171)**	**(301)**	**130**
Total Debt charges	**12,089**	**11,730**	**359**

~~The borrowing strategy undertaken in 2019/20 resulted in an overall saving~~

6.2 Housing

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enue Account (HRA)

6.2.1 ***Interest on HRA Revenue Balances Held*** – the HRA budgeted to receive investment income of £0.075m on its revenue balances in 2019/20 based on achieving an interest rate of 1.00%. Similar to the General Fund the investment strategy was able to out-perform both budget and benchmark resulting in a return of £0.134m in investment income a surplus of £0.059m

6.2.2 ***Capital Financing Costs*** - the HRA budgeted £3.528m for financing costs on debt for 2019/20. This consisted of £1.152m in loan principal, £2.326m in interest and £0.050m in expenses.

	Budget £'000	Out-turn £'000	Variance £'000
Principal	1,152	1,090	62
Interest	2,326	2,410	(84)
Expenses	50	79	(29)
Capital Financing costs	**3,528**	**3,579**	**(51)**
Investment income	**(75)**	**(135)**	**60**
	3,453	**3,444**	**9**

The borrowing strategy undertaken in 2019/20 resulted in an overall saving

6.3 In total, net debt financing costs were under spent by £0.178m, and when added to an over achievement in interest income of £0.190m resulted in an overall surplus of £0.368m which was reflected in the Council and HRA financial position at 2019/20.

7. Human Resources Implications

7.1 Not applicable.

8. Risk

8.1 ***Risk Implications of Adopting the Recommendations***

8.1.1 There are no risks associated with adopting the recommendations.

8.2 ***Risk Implications of Rejecting the Recommendations***

8.2.1 If the recommendations are rejected, then the Council will be non-compliant with the requirements contained in 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).

9. Equalities

9.1 The proposals in this report have been assessed through the Equality Impact Assessment Scoping process. There are no significant potential positive or negative equality impacts of agreeing the recommendations and therefore an Equalities Impact Assessment is not required. A copy of the Equalities Scoping Assessment is attached as Appendix 2.

10. Sustainable Development Implications

10.1 ***Considering Strategic Environmental Assessment (SEA)*** - This report does not propose or seek approval for a plan, policy, programme or strategy or document otherwise described which could be considered to constitute a plan, programme, policy or strategy.

11. Options Appraisal

11.1 An options appraisal has not been carried out in relation to the subject matter of this report.

12. Link to Council Plan

12.1 The matters referred to in this report contribute to the Council strategic objective of 'Improve the way that we work as a Council' and within that to the outcome 'Governance arrangements that provide an effective framework for decision making and scrutiny'.

13. Results of Consultation

13.1 There has been no public consultation on the contents of this report.

13.2 Consultation has taken place with Councillor Brian McGinley, Portfolio Holder for Resources and Performance, and the contents of this report reflect any feedback provided.

Background Papers **CIPFA Code of Practice for Treasury Management in Local Authorities**

Report to South Ayrshire Council of 28 February 2019 - Treasury Management and Investment Strategy 2019/20

Report to South Ayrshire Council of 21 January 2020 – Treasury Management Mid-Year Report - 2019/20

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Appendix 1

South Ayrshire Council

Treasury Management Annual Report 2019/20

Introduction

In accordance with the requirements of the CIPFA Code of Practice on Treasury Management in the Public Services, this report covers the following:

- Section 1 - The Council's Capital Expenditure and Financing 2019/20;
- Section 2 – The Council's overall borrowing need;
- Section 3 – Treasury Position as at 31 March 2020;
- Section 4 – The Strategy for 2019/20;
- Section 5 – The Economy and Interest Rates
- Section 6 – Borrowing Rates in 2019/20;
- Section 7 – Borrowing Out-turn 2019/20; and
- Section 8 – Investment Rates and Out-turn 2019/20.
- Section 9 – Other Issues

Section 1 The Council's Capital Expenditure and Financing 2019/20

1.1 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 have 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 requirement.

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

Table 1

Item	***2018/19 Actual £'000***	***2019/20 Estimate per Strategy***	***2019/20 Actual***
General Fund capital expenditure	31,766	72,037	39,102
HRA capital expenditure	21,505	32,636	22,794
Total	**53,271**	**104,673**	**61,896**
Resourced by:			
Government Grant & Other	(15,940)	(24,550)	(18,569)
Other funding identified	(21,189)	(8,973)	(18,263)
Borrowing :	**16,142**	**71,150**	**25,064**

1.3 The reason for the movement between planned expenditure/funding and actual out-turns for 2019/20 can be found in the General Services and HRA 2019/20 capital monitoring reports presented to Leadership Panel throughout 2019/20. The three largest examples (by value) of reprofiling of spend in to 2020/21 being:

- Archive & Registration Centre - £4.2m;
- Early Learning & Childcare projects - £3.6m; and
- HRA Major component replacement programme - £6m

Section 2 The Council's overall Borrowing Need

2.1 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 resources used to pay for the capital spend. It represents the 2019/20 unfinanced capital expenditure (Table 1), and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

2.2 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 manages the Council's cash position to ensure that sufficient cash is available to meet not only the capital plans but also to manage the daily cash flow requirements of funding its revenue commitments of payroll, suppliers, benefits etc.

2.3 This borrowing for capital expenditure may be sourced through 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 (internal borrowing).

2.4 ***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 as a loan repayment, to reduce the CFR. This is effectively a repayment of the borrowing need and 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
- by charging more than the scheduled debt amortisation for loans repayment.

2.5 The Council's CFR for the year is shown below, and represents a key prudential indicator. It includes PFI and leasing schemes on the balance sheet, which increase the Council's CFR, however no borrowing is actually required against these schemes as a borrowing facility is included in these contracts.

The undernoted table shows the Council's underlying borrowing requirement, inclusive of PPP and Finance lease arrangements, as at 31 March 2020.

Table 2

Capital Financing Requirement	**31 Mar 2019 £'000**	**31 Mar 2020 £'000**
Opening Balance	**295,511**	**301,593**
Add unfinanced capital expenditure	16,142	25,064
Add new OLTL obligations (PPP)	0	25,216
Less loans fund repayment	(6,967)	(6,616)
Less PPP/ finance lease repayment	(3,093)	(3,506)
Closing Balance	**301,593**	**341,751**

The borrowing activity is constrained by prudential indicators for gross borrowing, CFR, and by the authorised limit. The increasing CFR position reflects the Council's capital programme expenditure in 2019/20 and the resulting borrowing requirements to fund this investment.

2.6 ***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 (2018/19) plus the estimates of any additional capital financing requirement for the current (2019/20) 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.

The table below highlights the Council's gross borrowing position against the CFR.

Table 3

Item	***31 March 2019 £'000***	***31 March 2020 £'000***
Capital Financing Requirement (CFR)	301,593	341,748
Gross External Borrowing Position (including PPP and finance Lease)	304,605	338,383
Net Under/ (Over) Borrowed Position	**(3,012)**	**3,365**

The table above shows the CFR a slightly under-borrowed position at 31 March 2020 of £3.365m. This means the Council has used some internal borrowing from cash/ reserves to fund an element of its current capital expenditure requirements

This is a prudent position in the current interest rate environment given the cost of external borrowing compared with cash investment rates. The current strategy for 2020/21 is expected to maintain this under-borrowed position whilst closely monitoring longer term PWLB and market rates and consideration of potentially re-financing some of the temporary loan debt with longer term

2.7 ***Borrowing Prudential Indicators***

- **The Authorised Limit – Table 4** - the authorised limit is the maximum borrowing limit, beyond which the Council does not have the power to borrow. Table 4 below demonstrates that during 2019/20 the Council has maintained gross borrowing within its authorised limit.

- **The Operational Boundary – Table 4** – the operational boundary is the expected borrowing position of the Council during the year with headroom for daily cash flow variations. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached.

  The operational boundary position will be reviewed and updated in 2020/21 treasury reporting.
- **Actual Financing Costs as a Proportion of Net Revenue Stream – Table 5 -** this indicator identifies the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream of the Council.

Table 4

Item	***2018/19 £'000***	***2019/20 £'000***
Authorised Borrowing Limit External Debt	**339,898**	**414,821**
Borrowing	224,093	236,163
Other Long Term Liabilities	80,512	102,219
Total	**304,605**	**338,382**
Operational Boundary External Debt	**314,605**	**358,382**
Borrowing	224,093	236,163
Other Long Term Liabilities	80,512	102,219
Total	**304,605**	**338,382**

Table 5

Ratio of Financing Costs to Net Revenue Stream	***Actual 2018/19***	***Actual 2019/20***
General Services	6.03%	6.33%
HRA	10.31%	10.79%
Total	**6.65%**	**7.02%**

Section 3 Treasury Position

3.1 The Council's debt and investment position is administered by the treasury management team 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, and through officer activity detailed in the Council's Treasury Management Practices.

At the end of 2019/20 the Council's treasury (excluding borrowing by PFI and finance leases) position was as follows:

Table 6

	Borrowing position as at 31 March 2019		***Borrowing position as at 31 March 2020***		***Change in year***
	£'000	***Average interest rate %***	***£'000***	***Average interest rate %***	***£'000***
Long Term Borrowing					
Public Works Loans Board	117,893	5.03	139,961	4.57	22,068
Market – Fixed	15,000	1.11	5,000	1.24	(10,000)
LOBO (Option Loans)	41,200	4.52	41,200	4.52	0
Total Long Term Borrowing	**174,093**		**186,161**		**12,068**
Short Term Borrowing	50,000	0.77	50,000	0.97	0
Total External Borrowing	**224,093**	**2.86**	**236,161***	**2.83**	**12,068**
CFR (underlying borrowing need)	221,082		239,526		18,444
Over (Under) Borrowing	**3,012**		**(3,365)**		**(6,376)**
Investments	**(61,100)**	**0.79**	**(51,975)**	**0.72**	**9,125**

* The carrying amount of loans on the Council's balance sheet as at 31 March 2020 is £237.014m. The difference between this figure and the external borrowing shown in Table 6 above is £0.853m of equivalent interest rate accounting adjustments required by the Code of Practice on local authority accounting.

3.2 **Table 7** below details the profile of the Council's loan maturity periods as at 31 March 2020.

Table 7

Maturity analysis of Debt Outstanding at 31 March 2020	***PWLB £'000***	***Market £'000***	***LOBO (Option) £'000***	***Temp Borrowing***	***Total £'000***
Maturing within 1 year	1,004	0	0	50,000	51,004
Maturing 1 to 2 years	725	5,000	0	0	5,725
Maturing 2 to 5 years	6,344	0	3,000	0	9,344
Maturing 5 to 10 years	7,914	0	3,000	0	10,914
Maturing 10 to 20 years	41,303	0	0	0	41,303
Maturing 20 to 30 years	9,006	0	10,500	0	19,506
Maturing 30 to 40 years	58,665	0	5,000	0	63,665
Maturing 40 to 50 years	15,000	0	9,700	0	24,700
Maturing > 50 years	0	0	10,000	0	10,000
Total	***139,961***	***5,000***	***41,200***	***50,000***	***236,161***

3.3 **Loans fund -** where a local authority has a Housing Revenue Account, the HRA should be reported separately from the General Fund. The reporting on the commitment to repay loans fund advances is for repayments only and does not include any interest costs. The Loans Fund balances are set out in Table 8 and Table 8(a) below:

Table 8 – Loans Fund Advances to General Fund

Loans Fund	**31 March 2019 (£'000)**	**31 March 2020 (£'000)**
Opening Balance	152,684	159,366
Add advances	12,552	15,799
Less repayments	(5,869)	(5,526)
Closing Balance	**159,366**	**169,639**

Table 8(a) – Loans Fund Advances to HRA

Loans Fund	**31 March 2019 (£'000)**	**31 March 2020(£'000)**
Opening Balance	56,834	59,325
Add advances	3,589	9,266
Less repayments	(1,098)	(1,090)
Closing Balance	**59,325**	**67,501**

Section 4 Strategy for 2019/20

4.1 Investment returns remained low during 2019/20. The expectation for interest rates within the treasury management strategy for 2019/20 was that Bank Rate would stay at 0.75% during 2019/20 as it was not expected that the Monetary Policy Committee (MPC) would be able to deliver on an increase in Bank Rate until the Brexit issue was finally settled. However, there was an expectation that Bank Rate would rise after that issue was settled, but would only rise to 1.00% during 2020.

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

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

4.2 In this scenario, the treasury strategy was to replace temporary borrowing of £50m in the short-term markets at maturity, taking advantage of cheap funding available, particularly in the inter local authority markets and to also fund the majority of the

Council and HRA additional borrowing requirements from long term external borrowing (PWLB).

HM Treasury imposed two changes in the margins over gilt yields for PWLB rates in 2019-20 without any prior warning; the first on 9 October 2019, added an additional 1% margin over gilts to all PWLB rates. That increase was then partially reversed for some forms of borrowing on 11 March 2020, at the same time as the Government announced in the Budget a programme of increased spending on infrastructure expenditure. It also announced that there would be a consultation with local authorities on possibly further amending these margins; this ended on 31 July.

Section 5 Economy and Interest Rates

5.1 **UK. Brexit**. The main issue in 2019 was the struggles in the House of Commons to agree on one way forward for the UK over the issue of Brexit. This resulted in the resignation of Teresa May as the leader of the Conservative minority Government and the election of Boris Johnson as the new leader, on a platform of taking the UK out of the EU on 31 October 2019. The House of Commons could still not agree a way forward and so a general election in December settled the matter once and for all by a decisive victory for the Conservative Party: that then enabled the UK to leave the EU on 31 January 2020. However, this still leaves much uncertainty as to whether there will be a reasonable trade deal achieved by the target deadline of the end of 2020. It is also unclear as to whether the coronavirus outbreak may yet impact on this deadline; however, the second and third rounds of negotiations have already had to be cancelled due to the virus.

Economic growth in 2019 has been very volatile with quarter 1 unexpectedly strong at 0.5%, quarter 2 extremely poor at -0.2%, quarter 3 bouncing back up to +0.5% and quarter 4 flat at 0.0%, +1.1% y/y. 2020 started with optimistic business surveys pointing to an upswing in growth after the ending of political uncertainty as a result of the decisive result of the general election in December settled the Brexit issue. However, the three monthly GDP statistics in January were disappointing, being stuck at 0.0% growth. Since then, there have major changes to the whole world economy as a result of the coronavirus outbreak. It now looks likely that the closedown of whole sections of the economy will result in a fall in GDP of at least 15% in quarter two. What is uncertain, however, is the extent of the damage that will be done to businesses by the end of the lock down period, when the end of the lock down will occur, whether there could be a second wave of the outbreak, how soon a vaccine will be created and then how quickly it can be administered to the population. This leaves huge uncertainties as to how quickly the economy will recover.

After the MPC raised Bank Rate from 0.50% to 0.75% in August 2018, Brexit uncertainty caused the MPC to make no further changes until March 2020; at this point it was very clear that the coronavirus outbreak posed a huge threat to the economy of the UK. Two emergency cuts in Bank Rate from 0.75% occurred in March, first to 0.25% and then to 0.10%. These cuts were accompanied by an increase in quantitative easing (QE), essentially the purchases of gilts (mainly) by the Bank of England of £200bn. The Government and the Bank were also very concerned to stop people losing their jobs during this lock down period. Accordingly, the Government introduced various schemes to subsidise both employed and self-employed jobs for three months while the country is locked down. It also put in place a raft of other measures to help businesses access loans from their banks, (with the Government providing guarantees to the banks against losses), to tide them over the lock down period when some firms may have little or no income. However, at the time of writing, this leaves open a question as to whether some firms will be solvent, even if they take out such loans, and some may also choose to close as there is, and will be, insufficient demand for their services. At the time of writing, this is a rapidly evolving situation so there may be further measures to come from the Bank and the Government in the future. The measures to support jobs and businesses already taken by the Government will result in a huge increase in the annual budget deficit in 2020/21 from 2%, to nearly 11%. The ratio of debt to GDP is also likely to increase from 80% to around 105%. In the Budget in March, the Government also announced a large increase in spending on infrastructure; this will also help the economy to recover once the lock down is ended. Provided the coronavirus outbreak is brought under control and the lock down is eased, then it is hoped that there would be a sharp recovery, but one that would take a prolonged time to fully recover previous lost momentum.

Inflation has posed little concern for the MPC during the last year, being mainly between 1.5 – 2.0%. It is also not going to be an issue for the near future as the world economy will be heading into a recession which is already causing an increase in the supply of oil which has fallen sharply in price. Other prices will also be under downward pressure while wage inflation has also been on a downward path over the last half year and is likely to continue that trend in the current environment. While inflation could even turn negative in the Eurozone, this is currently not likely in the UK.

Employment had been growing healthily through the last year but it is has obviously declined between March – April 2020. The good news over the last year is that wage inflation has been significantly higher than CPI inflation which means that consumer real spending power had been increasing and so will have provided support to GDP growth. However, while people cannot leave their homes to do non-food shopping, retail sales will also take a big hit.

5.2. **EUROZONE (EZ)**. The annual rate of GDP growth has been steadily falling, from 1.8% in 2018 to only 0.9% y/y in quarter 4 in 2019. The European Central Bank (ECB) ended its programme of quantitative easing (QE) purchases of debt in December 2018, which meant that the central banks in the US, UK and EU had all ended the phase of post financial crisis expansion of liquidity supporting world financial markets by purchases of debt. However, the downturn in EZ 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. At its March 2019 meeting it announced a third round of targeted longer-term refinancing operations (TLTROs); this provided banks with cheap two year maturity borrowing every three months from September 2019 until March 2021. However, since then, the downturn in EZ and world growth has gathered momentum so at its meeting in September 2019, it cut its deposit rate further into negative territory, from -0.4% to -0.5% and announced a resumption of quantitative easing purchases of debt to start in November at €20bn per month, a relatively small amount, plus more TLTRO measures. Once coronavirus started having a major impact in Europe, the ECB took action in March 2020 to expand its QE operations and other measures to help promote expansion of credit and economic growth. What is currently missing is a coordinated EU response of fiscal action by all national governments to protect jobs, support businesses directly and promote economic growth by expanding government expenditure on e.g. infrastructure; action is therefore likely to be varying.

5.3 **USA**. Growth in quarter 1 of 2019 was strong at 3.1% but growth fell back to 2.0% in quarter 2 and 2.1% in quarters 3 and 4. The slowdown in economic growth resulted in the Federal Reserve Board (Fed) cutting rates from 2.25-2.50% by 0.25% in each of July, September and October. Once coronavirus started to impact the US in a big way, the Fed took decisive action by cutting rates twice by 0.50%, and then 1.00%, in March, all the way down to 0.00 – 0.25%. Near the end of March, Congress agreed a $2trn stimulus package (worth about 10% of GDP) and new lending facilities announced by the Fed which could channel up to $6trn in temporary financing to consumers and firms over the coming months. Nearly half of the first figure is made up of permanent fiscal transfers to households and firms, including cash payments of $1,200 to individuals.

The loans for small businesses, which convert into grants if firms use them to maintain their payroll, will cost $367bn and 100% of the cost of lost wages for four months will also be covered. In addition there will be $500bn of funding from the Treasury's Exchange Stabilization Fund which will provide loans for hard-hit industries, including $50bn for airlines.

However, all this will not stop the US falling into a sharp recession in quarter 2 of 2020; some estimates are that growth could fall by as much as 40%. The first two weeks in March of initial jobless claims already hit a total of 10 million and look to increase.

5.4 **CHINA**. Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium-term risks have also been increasing. The major feature of 2019 was the trade war with the US. However, this has been eclipsed by being the first country to be hit by the coronavirus outbreak; this resulted in a lock down of the country and a major contraction of economic activity in February-March 2020. While it appears that China had managed to contain the virus by the end of March, these are still early days to be confident and it is clear that the economy is going to take some time to recover its previous rate of growth. Ongoing economic issues remain, in needing to make major progress to eliminate excess industrial capacity and to switch investment from property construction and infrastructure to consumer goods production. It also needs to address the level of non-performing loans in the banking and credit systems.

5.5 **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. It appears to have missed much of the domestic impact from coronavirus in 2019-20 but the virus is at an early stage there.

5.6 **WORLD GROWTH**. The trade war between the US and China on tariffs was a major concern to financial markets and was depressing worldwide growth during 2019, as any downturn in China would spill over into impacting countries supplying raw materials to China. Concerns were particularly focused on the synchronised general weakening of growth in the major economies of the world. These concerns resulted in government bond yields in the developed world falling significantly during 2019. In 2020, coronavirus is the big issue which is going to sweep around the world and have a major impact in causing a world recession in growth in 2020.

Section 6 Borrowing Rates in 2019/20

6.1 ***PWLB Borrowing Rates -***

PWLB rates are based on, and are determined by, gilt (UK Government bonds) yields through HM Treasury determining a specified margin to add to gilt yields. There was much speculation during the second half of 2019 that bond markets were in a bubble which was driving bond prices up and yields down to historically very low levels. The context for that was heightened expectations that the US could have been heading for a recession in 2020, and a general background of a downturn in world economic growth, especially due to fears around the impact of the trade war between the US and China, together with inflation generally at low levels in most countries and expected to remain low; these conditions were conducive to very low bond yields. While inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers: this means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. This has pulled down the overall level of interest rates and bond yields in financial markets over the last 30 years. We have therefore seen, over the last year, many bond yields up to 10 years in the Eurozone turn negative. In addition, there has, at times, been an inversion of bond yields in the US whereby 10 year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession. The other side of this coin is that bond prices are elevated as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities.

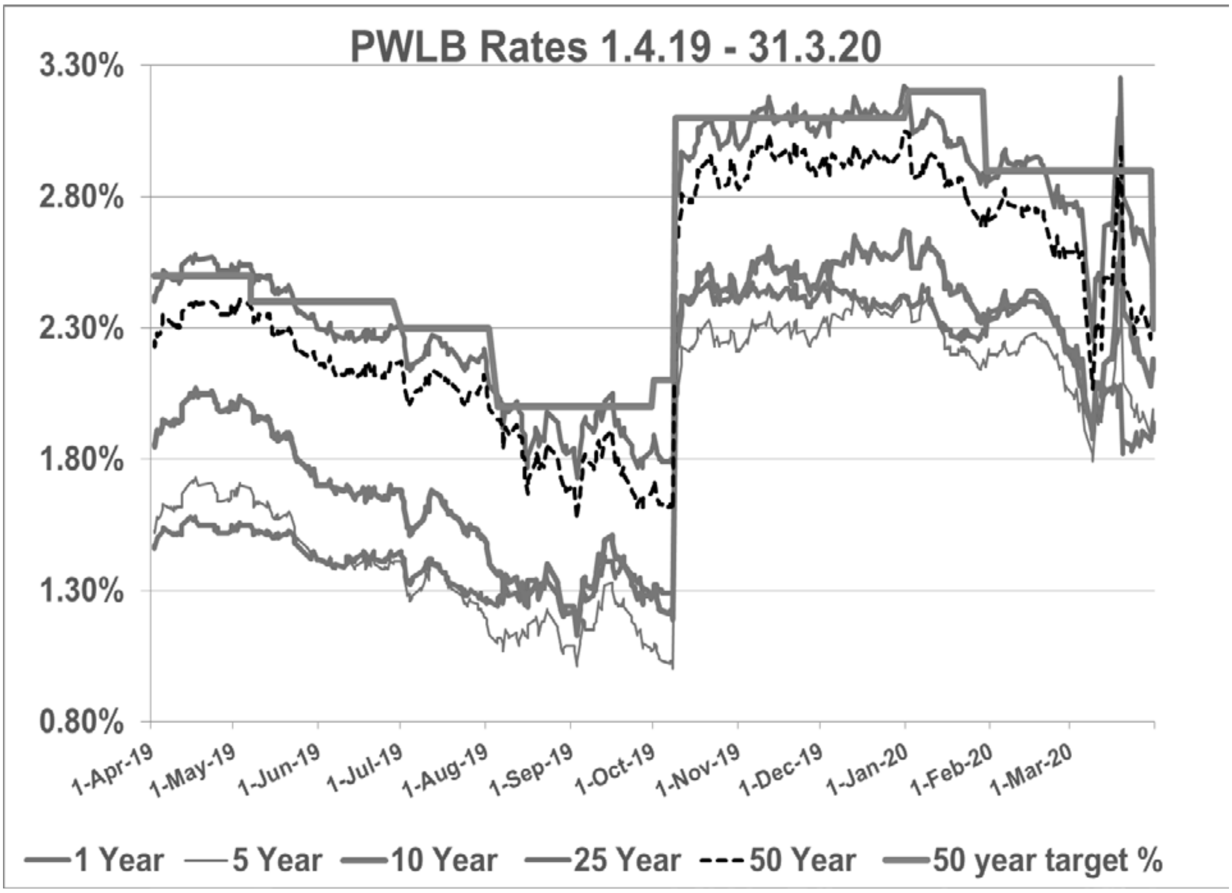
Gilt yields were on a generally falling trend during the last year up until the coronavirus crisis hit western economies. Since then, gilt yields have fallen sharply to unprecedented lows as investors have panicked in selling shares in anticipation of impending recessions in western economies, and moved cash into safe haven assets i.e. government bonds. However, major western central banks also started quantitative easing purchases of government bonds which will act to maintain downward pressure on government bond yields at a time when there is going to be a huge and quick expansion of government expenditure financed by issuing government bonds; (this would normally cause bond yields to rise). At the close of the day on 31 March, all gilt yields from 1 to 5 years were between 0.12 – 0.20% while even 25-year yields were at only 0.83%.

However, HM Treasury has imposed two changes in the margins over gilt yields for PWLB rates in 2019-20 without any prior warning; the first on 9 October 2019, added an additional 1% margin over gilts to all PWLB rates. That increase was then partially reversed for some forms of borrowing on 11 March 2020, at the same time as the Government announced in the Budget a programme of increased spending on infrastructure expenditure. It also announced that there would be a consultation with local authorities on possibly further amending these margins; this ended on 4 June. It is clear that the Treasury intends to put a stop to local authorities borrowing money from the PWLB to purchase commercial property if the aim is solely to generate an income stream.

Following the changes on 11 March 2020 in margins over gilt yields, the current situation is as follows: -

- PWLB Standard Rate is gilt plus 200 basis points (G+200bps)
- PWLB Certainty Rate is gilt plus 180 basis points (G+180bps)
- PWLB HRA Standard Rate is gilt plus 100 basis points (G+100bps)
- PWLB HRA Certainty Rate is gilt plus 80bps (G+80bps)
- Local Infrastructure Rate is gilt plus 60bps (G+60bps)

There is likely to be little upward movement in PWLB rates over the next two years as it will take national economies a prolonged period to recover all the momentum they will lose in the sharp recession that will be caused during the coronavirus shut down period. Inflation is also likely to be very low during this period and could even turn negative in some major western economies during 2020-21.



Link Asset Services Interest Rate View	31.3.20							
	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 Month LIBID	0.45	0.40	0.35	0.30	0.30	0.30	0.30	0.30
6 Month LIBID	0.60	0.55	0.50	0.45	0.40	0.40	0.40	0.40
12 Month LIBID	0.75	0.70	0.65	0.60	0.55	0.55	0.55	0.55
5yr PWLB Rate	1.90	1.90	1.90	2.00	2.00	2.00	2.10	2.10
10yr PWLB Rate	2.10	2.10	2.10	2.20	2.20	2.20	2.30	2.30
25yr PWLB Rate	2.50	2.50	2.50	2.60	2.60	2.60	2.70	2.70
50yr PWLB Rate	2.30	2.30	2.30	2.40	2.40	2.40	2.50	2.50

Section 7 Borrowing Out-turn for 2019/20

7.1 During 2019/20 the Council funded part of the capital borrowing requirement in the short term market, maintaining temporary borrowing at £50.000m, at March 2020. However, additional long term borrowing (PWLB) of £25.000m was also undertaken, taking advantage of low interest rates and gaps in the borrowing maturity profile. The Council were in an under-borrowed position of £3.365m for

2019/20. The Council has not borrowed more than, or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed.

7.2 During 2020/21 focus will be on monitoring longer term rates and looking to borrow longer term to meet the CFR and at the same time look to reduce the temporary borrowing of £50.000m on the short term market.

7.2 During 2019/20 the actual borrowing and repayments of external debt transacted are shown in Table 10 below. This shows temporary borrowing being replaced on maturity and longer term borrowing being undertaken, a prudent position in the current interest rate environment. The Council's policy is to ensure that not more than 25% of long term loans are due to mature within any financial year. The indicator for maturing debt of 22% (within one year) is 3% below the maturity limit indicator.

Table 10

Loan Type	**Borrowed 2019/20 £'000**	**Repaid 2019/20 £'000**	**Net £'000**
PWLB	25,000	(2,931)	22,069
Market Loans	0	(10,000)	(10,000)
Temporary borrowing	75,000	(75,000)	0
	100,000	**(87,931)**	**12,069**

7.3 ***Debt Re-scheduling*** – no external debt was re-scheduled during 2019/20 as the average differential of 1% between PWLB new borrowing rates and premature redemption rates made early repayment of loans expensive and unviable due to the premiums that would be payable.

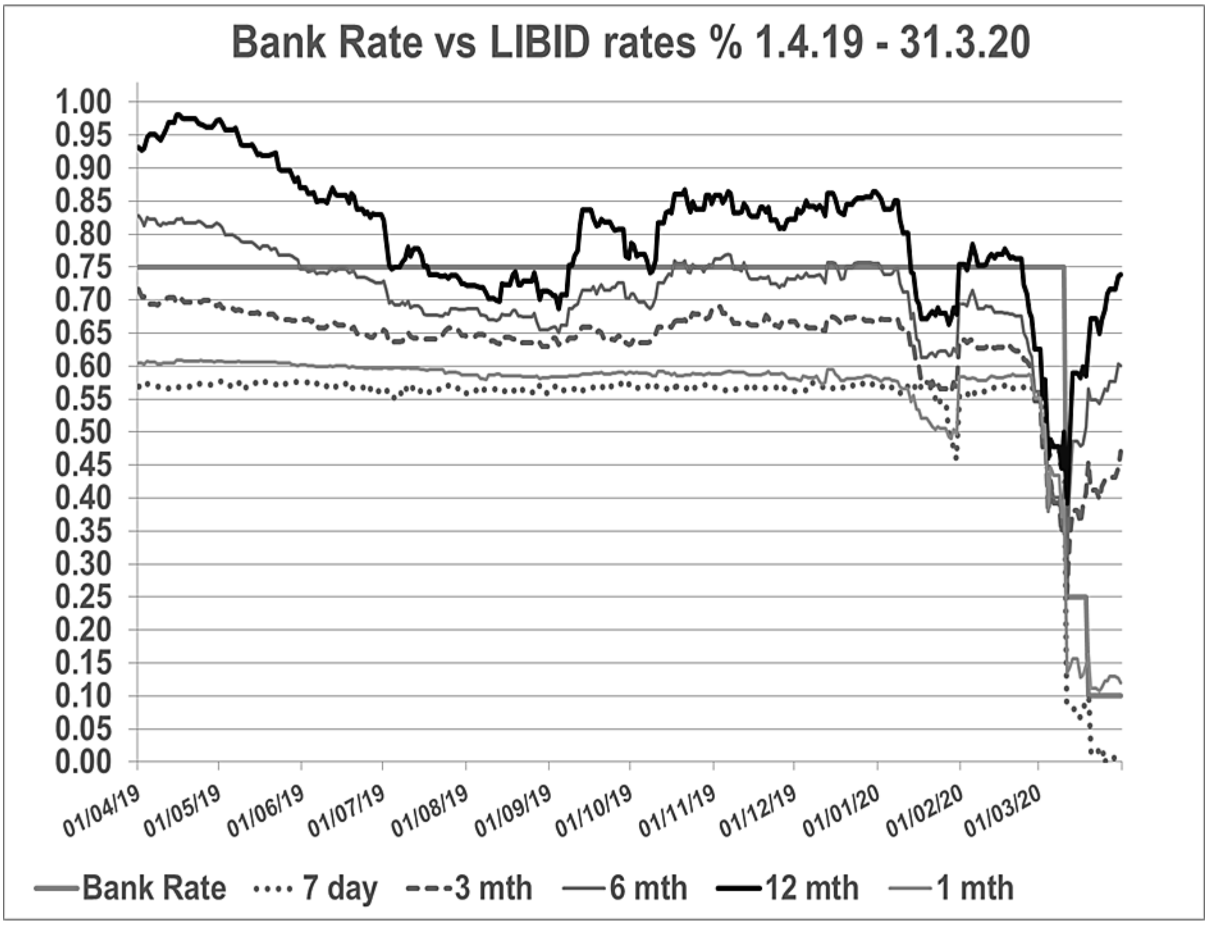
Section 8 Investment Rates, Out-turn and Policy in 2019/20

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

Rising concerns over the possibility that the UK could leave the EU at the end of October 2019 caused longer term investment rates to be on a falling trend for most of April to September. They then rose after the end of October deadline was rejected by the Commons but fell back again in January before recovering again after the 31 January departure of the UK from the EU. When the coronavirus outbreak hit the UK in February/March, rates initially plunged but then rose sharply back up again due to a shortage of liquidity in financial markets.

Fig 2 and 3 below shows the bank rate and average of short term rates generally available in the market for investment period up to 1 year.

Fig 2



Money Market Investment Rates 2019/20

Fig 3

	Bank Rate	7 day	1 mth	3 mth	6 mth	12 mth
High	0.75	0.58	0.61	0.72	0.83	0.98
High Date	01/04/2019	09/05/2019	15/04/2019	01/04/2019	01/04/2019	15/04/2019
Low	0.10	0.00	0.11	0.26	0.31	0.39
Low Date	19/03/2020	25/03/2020	23/03/2020	11/03/2020	11/03/2020	11/03/2020
Average	0.72	0.53	0.56	0.63	0.70	0.80
Spread	0.65	0.58	0.50	0.46	0.52	0.59

8.3 **Investment Out-turn –** the Council maintained an average balance of £57.6m of internally managed investment funds. The internally managed funds earned an average rate of return of 0.88%.

The comparable performance indicator is the average 3-Month LIBID rate which was 0.52%.

Table 11

	Average Value of Investments Held	***Rate of Return***	***Benchmark Return****
Investments	£57.623m	0.88%	0.52%

**The benchmark return used is the 3 month London Inter-bank bid rate (LIBID) of 0.52%. This represents the average rate that would be realised if deposits were placed on the inter-bank money market for continuing periods of 3 months throughout 2019/20.*

8.4 **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 28 February 2019. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.).

The investment activity during the year met with the approved strategy, and the Council had no liquidity difficulties.

8.5 **Current Council Investments held at 31 March 2020.**

Table 12

Class	Type	Start Date	Maturity Date	Counterparty	Profile	Rate	Principal £000
Deposit	Fixed	09/08/2019	07/08/2020	Cambridgeshire County Council	Maturity	0.82	5,000
Deposit	Fixed	14/08/2019	12/08/2020	Slough Borough Council	Maturity	0.83	5,000
Deposit	Fixed	26/11/2019	24/11/2020	Lancashire County Council	Maturity	0.95	5,000
Deposit	Fixed	02/12/2019	02/09/2020	London Borough of Islington	Maturity	0.75	5,000
Deposit	Fixed	11/12/2019	09/12/2020	Thurrock Council	Maturity	0.95	5,000
Fixed Total							**25,000**
Deposit	Variable	10/05/2016	-	Bank of Scotland (Call A/c)	Variable	0.05	1,975
Deposit	Variable	10/11/2015	-	Bank of Scotland (175d)	Variable	1.13	5,000
Deposit	Variable	02/09/2019	-	Bank of Scotland (95d)	Variable	0.60	10,000
Deposit	Variable	-	-	Federated (Prime Rate Class3)	Variable	0.43	10,000
Call Total							**26,975**
Overall Total							**51,975**

Section 9 Other Issues

9.1 **Sources of borrowing** - Although PWLB remains a low risk source of long term borrowing due to recent rate changes and the ongoing consultation with local authorities on the future of PWLB borrowing other borrowing institutions may be looked at to remove the reliance on PWLB for long term borrowing needs.

9.2 **Changes in risk appetite** - The 2018 CIPFA Codes and guidance notes have placed enhanced importance on risk management. South Ayrshire Council has a low risk appetite and as such would look at all aspects before making any changes to the current strategy and members would be made fully aware of any such changes.

9.3 **IFRS 16** - The implementation of IFRS 16 bringing currently off balance sheet leased assets onto the balance sheet has been delayed for one year from 2019/20 due to Covid-19. However, this may attract additional audit scrutiny due to this delay. Work will therefore be progressed in this area throughout 2020/21.

Appendix 2

1. Proposal details

Proposal Title	Lead Officer
Treasury Management Annual Report 2019/20	**Tim Baulk**

2. Which communities, groups of people, employees or thematic groups do you think will be, or potentially could be, impacted upon by the implementation of this proposal? Please indicate whether these would be positive or negative impacts

Community, Groups of People or Themes	Negative Impacts	Positive impacts
The whole community of South Ayrshire	-	-
People from different racial groups, ethnic or national origin.	-	-
Women and/ or men (boys and girls)	-	-
People with disabilities	-	-
People from particular age groups for example Older people, children and young people	-	-
Lesbian, gay, bisexual and heterosexual people	-	-
People who are proposing to undergo, are undergoing or have undergone a process to change sex	-	-
Pregnant women and new mothers	-	-
People who are married or in a civil partnership	-	-
People who share a particular religion or belief	-	-
Thematic Groups: Health, Human Rights, Rurality and Deprivation	-	-

3. Do you have evidence or reason to believe that the proposal will support the Council to:

General Duty and other Equality Themes	Level of Negative and/ or Positive Impact (high, medium or low)
Eliminate discrimination and harassment faced by particular communities or groups	Low impact
Promote equality of opportunity between particular communities or groups	Low impact
Foster good relations between particular communities or groups	Low impact
Promote positive attitudes towards different communities or groups	Low impact
Increase participation of particular communities or groups in public life	Low impact
Improve the health and wellbeing of particular communities or groups	Low impact
Promote the human rights of particular communities or groups	Low impact
Tackle deprivation faced by particular communities or groups	Low impact

4. Summary Assessment

Is a full Equality Impact Assessment (EQIA) required? (A full EQIA must be carried out on all high and medium impact proposals**)**	**Yes**		**No**	x

Rationale for decision:

This report presents to the Panel the annual report of treasury management activities for 2019/20. Their decision on this has no specific equality implications.

Signed :	**Tim Baulk**	Head of Service
Date:	**4 August 2020**	Copy to equalities@south-ayrshire.gov.uk