PERTH AND KINROSS COUNCIL

1 July 2015

ANNUAL TREASURY REPORT 2014/15

Report by the Head of Finance

PURPOSE OF REPORT

This report summarises the Council's treasury activities for the 2014/15 financial year and compares actual performance with the approved Treasury and Investment Strategy for 2014/15.

1. BACKGROUND / MAIN ISSUES

1.1 A requirement of the Council's approved Treasury Management Practice 6 (TMP6 – Reporting Requirements & Management Information Arrangements) is the reporting to the Council of the expected treasury activity for the forthcoming year (i.e. the Treasury and Investment Strategy) and the subsequent reporting of the actual results and activities (i.e. this Annual Treasury Report). The Council meeting on 26 February 2014 approved the Treasury Strategy for the 7 financial years 2014/15 to 2020/21 and the annual Investment Strategy for 2014/15 (Report No. 14/77 refers).

1.2 This Annual Treasury Report covers:

- The Council's treasury position
- The forecast economic outlook and borrowing strategy for 2014/15
- The actual economic situation for 2014/15
- Actual long term borrowing and debt restructuring in 2014/15
- The investment strategy and outturn for 2014/15
- Compliance with treasury policies and limits during 2014/15
- The Accounts Commission report on Borrowing and Treasury Management in Councils

2. THE TREASURY POSITION

2.1 In order to place this report in context, the Council's Treasury position at the beginning and at the end of the year is shown below:

	Principal Outstanding 31 Mar 2014 £M	Average Rate %	Principal Outstanding 31 Mar 2015 £M	Average Rate %
Fixed Rate/Long Term Funding				
• Public Works Loan Board (PWLB)	148.7	4.15	194.5	4.06
• Market & Local Authority Bonds	48.2	4.26	48.2	4.26
• Other Loans & Bonds	0.0	0.00	0.3	0.00
	196.9	4.17	243.0	4.10
Variable Rate/Short Term Funding				
• Temporary Loans	1.4	0.10	1.4	0.10
• Internal Loans	0.3	0.75	1.7	0.73
	1.7	0.21	3.1	0.45
TOTAL DEBT	**198.6**	**4.14**	**246.1**	**4.05**
SHORT TERM INVESTMENTS	**24.6**	**0.80**	**56.5**	**0.68**

3. THE FORECAST ECONOMIC OUTLOOK AND BORROWING STRATEGY 2014/15

3.1 The strategy for the year was based on the view that the global economy would continue to experience economic volatility and low interest rates, which made it difficult to forecast interest rates with any degree of certainty. It was, however, expected that the Bank Base rate would remain at 0.5% throughout the year, and not start increasing until 2015/16. Longer term interest rates were expected to rise slowly throughout 2014/15 and future years. Shorter and medium term rates were expected to follow a similar pattern but remain at a lower level than longer term rates.

3.2 The effect on interest rates for the UK was therefore expected to be as follows:

- Short-Term Interest rates – it was anticipated that the Bank Rate would remain at its low level of 0.5% throughout 2014/15, with steady increases in subsequent years, commencing in 2015.

- Long-Term Interest Rates – The view on longer-term fixed rates was that long term Public Works Loan Board (PWLB) rates for 10 years would slowly increase during 2014/15, reaching around 3.90% by the year end (March 2015). The 50 year rate was expected to reach around 4.70% by the end of year.

3.3 The estimated capital borrowing requirement for 2014/15 at the start of the year was £20.4M, whilst the new borrowing requirement over the whole seven year period totalled £147.4M, and included refinancing of maturing debt over the 7 year period. This was particularly significant as the start of 2014/15 coincided with the period of lowest forecast interest rates, and which were expected to steadily rise over the year. Effective Treasury Management considers the longer-term position in order to minimise costs and risks in the Council's portfolio. This includes consideration of borrowing for future year requirements earlier within the 7 year period, whilst rates were at their forecast low point. This approach is consistent with the Prudential Code, however, it must also be considered in conjunction with the assessment of the associated additional risks and low returns from the resultant increase in the level of investments in the short term. The Strategy in the previous year (2013/14) had been to defer all new borrowing and thus reduce investment balances, and by the end of that year the level of investments had reduced to their minimum (core) level felt desirable.

3.4 The above factors gave rise to the anticipated strategy that the full new long term borrowing requirement would be required during the year. Whilst the use of short term borrowing would be cheaper than long term borrowing, the use of longer term borrowing would give rise to longer term savings and reduce the refinancing risk in later years. As the strategy considers the longer term position of the Council, consideration would also be given to accelerating some borrowing from future year's requirements if interest rates started to increase. LOBO's (Lender Option Borrowers Option) or other appropriate market instruments were also to be considered in such circumstances, and used where they offered favourable rates in comparison to PWLB. However, these would be considered in conjunction with the associated risks with LOBO's due to their variable rate nature after their initial period elapses, and their less flexible terms.

3.5 The Council has traditionally adopted a policy of minimising exposure to risk, thus favouring fixed longer term borrowing. However, it was acknowledged that there were several factors which could impact on interest rates in the year ahead. Therefore the Council would continue to apply its well developed approach to managing risk and monitoring interest rates with a view to reviewing this strategy should circumstances change.

4. ACTUAL ECONOMIC SITUATION 2014/15

4.1 2014/15 proved to be another unsettled year for the financial markets. Economic growth in the UK was at a relatively low level at the start of the year, although it did increase over the first two quarters before slowing in the final two quarters. Consumer Price Index (CPI) inflation fell steadily over the year from 1.6% at the start of the year, ending at 0.0% in March 2015. Employment levels also continued to grow steadily throughout the year. The relatively weak level of growth and low inflation in the UK led the Bank of England to leave the Bank Rate unchanged at 0.5% throughout the year.

4.2 Gilt yields were relatively steady over the first quarter of the year as the economic environment improved. However, over the next two quarters gilt yields showed a steady downward movement due to geo-political concerns about Ukraine, Russia, Syria, and the Ebola crisis, as well as economic concerns over the Eurozone, China and Japan and the large fall in the price of oil. Over the final quarter gilt yields initially continued to fall, however, they then started to increase as economic conditions improved before falling slightly at the end of March 2015. Consequently, interest rates for all borrowing periods over one year ended the year significantly lower than at the start of the year.

4.3 Investment deposit rates also reduced steadily over the year from an already relatively low level. This reflected new liquidity and capital requirements of banks, making it less attractive for them to hold short term deposits, as well as expectations that any increase in the Bank rate would be deferred even further.

4.4 All PWLB fixed rates fell over the year, and were lower than forecast in the original strategy. For example, the 10 year PWLB rate at 1 April 2014 was 3.8% and had fallen to 2.5% by February 2015, before finishing the year at 2.7%. Similarly, the 50 year PWLB rate was 4.5% in April 2014, and fell to 3.1% by February 2015, ending the year at 3.3%. The same pattern emerged for all PWLB rates and various PWLB rates for the year are shown graphically at Appendix I.

5. ACTUAL LONG TERM BORROWING AND DEBT RESTRUCTURING

5.1 The actual treasury activities during 2014/15 are comprehensively detailed in the four quarterly reports previously submitted to the Council (Report No's 14/431, 14/547, 15/93 and 15/181 refer).

5.2 As noted in Section 3.3, before the start of the year, the Council estimated that the new Capital borrowing for 2014/15 would be £20.4M, and the actual borrowing strategy would be subject to review, for example if interest rates started to increase rapidly. This may have included borrowing of future year's requirements.

5.3 A total of £55M of longer-term borrowing was undertaken over the course of the year from the PWLB at an average rate of 3.65% for an average of 42 ½ years. This, therefore, included borrowing from future year's requirements, which includes significant maturing debt requiring to be financed. It also followed a period of falling rates, against a forecast that they were to start rising steadily over the next few years.

5.4 There was £9M of maturing debt with the PWLB repaid during the year, which related to loans of between 5 and 6 years reaching maturity with an average interest rate of 3.14%. A further £161,290 of scheduled instalments was repaid on the EIP (Equal Instalment of Principal) loan. Due to the low interest rates during the year, there were no rescheduling or premature repayments of debt made.

5.5 The average PWLB debt portfolio rate for the Council reduced from 4.15% at the start of the year, to 4.06% at the end of the year for the total of £194.5M PWLB debt held by the Council. The total PWLB borrowing increased by £45.8M over the year, as a result of the activities discussed above, and the average portfolio rate reduced as a result of the new borrowing being at a lower rate than the overall average rate. There were no movements in Market and Local Authority Bonds during the year, whilst an interest-free loan of £341,337 was drawn down in the year to support capital expenditure on energy-efficient street lighting. Overall, the Council's total Fixed Rate borrowing increased by £46.1M to £243M, whilst the average rate reduced slightly from 4.17% to 4.10%.

5.6 This increase in the portfolio follows on from the previous borrowing strategy to reduce investment balances by not undertaking any further borrowing in 2012/13 and 2013/14. This strategy was successfully implemented, with the level of investments reducing to the minimum desirable level of around £20M by March 2014. However, with the ongoing capital borrowing requirement and the need to replace significant levels of maturing debt, the strategy for 2014/15 was to recommence borrowing, and possibly accelerating future year's borrowing. This strategy was also successfully implemented, as outlined in the above sections.

5.7 As a result of the above strategy and actual treasury activities in the year, the Council's average Consolidated Loans Fund (CLF) interest rate increased from 3.42% in 2013/14 to 3.60% in 2014/15 (based on applying statutory guidance). This increase reflects the increased level of borrowing in the year, which it is anticipated will give rise to interest savings in future years against future borrowing rates. A comparison of the Council's CLF rate over recent years with the average for other Scottish Local authorities is shown graphically at Appendix II. Whilst figures for the Scottish average have not yet been published for 2014/15, this graph shows that over time, this Council's average borrowing costs have reduced year-on-year at a faster rate than the Scottish average. This equates to savings in Loan Charges of over £2.5M per annum compared to the Scottish average.

6. INVESTMENT STRATEGY AND OUTURN 2014/15

6.1 Shorter term deposit rates remained at low levels throughout the year, and steadily reduced. This reduction reflected new regulatory capital requirements for banks, which made it less attractive for banks to hold short term cash deposits, as well as economic forecasts which suggested that the Bank Rate (which remained at 0.5%) would not increase until at least 2015 or 2016. Counterparty concerns mostly related to the new Bank Recovery and Resolution Directive 2013, whereby certain deposits in banks that fail (including local authority deposits) will be used towards meeting the liabilities of the failing bank ("bail-in") as opposed to be being bailed-out by taxpayers. This also implied that such banks would not in future receive support from the Government, and they, therefore, required to strengthen their own capital resources. This highlighted the continuing need for caution in treasury investment activity.

6.2 As a result of the additional new long term borrowing undertaken in the year outlined above, together with the positive cashflow in the first part of the year, the level of investments also increased. As the year progressed, more fixed term deposits were made but for shorter durations, and the higher interest rates available for longer time periods (up to 12 months) were only utilised with “semi-nationalised” banks (and within counterparty limits). For shorter investment periods, the notice deposit accounts and money market funds held by the Council provided a higher return on investments than rates available on shorter term fixed deposits in the money markets. These facilities also helped meet daily cashflow requirements and keeping within counterparty limits.

6.3 During the year, no investment was made for more than 12 months. All the investment activities were in line with the approved strategy for 2014/15. As a result of this strategy, the average rate achieved on investments outstanding at 31 March 2014 was 0.68%. This reflected a reduction from that achieved in the previous year, due to falling interest rates. For further comparison, the average temporary borrowing rate for the year was 0.15%. Total interest received on investments in 2014/15 amounted to £380,432 (£444,601 in 2013/14).

6.4 The original Strategy also anticipated that investments would not exceed £50M during the year unless, for example, new borrowing was undertaken or the Council’s expenditure during the year was later than anticipated. As described in Section 5.3, £55M of new borrowing was undertaken during the year, of which £40M was borrowed in the first half of the year. Consequently, the level of investments was higher than expectations and peaked at £82.66M on 17 September 2014. The level of investments slowly reduced over the remainder of the year and at the end of the financial year stood at £56.5M.

6.5 All financial investments by the Council’s Common Good Funds were made through the Council’s Loans Fund, in accordance with the Common Good Fund’s policy for Permitted Investments. This included the amendment to the policy in June 2014 (report 14/300 refers) which extended the Common Good investment options to include fixed deposits with the Loans Fund. As a result, £1,728,000 of Common Good funds were placed on deposit with the Loans Fund for periods of 3 and 12 months at an average rate of 0.73%.

6.6 Any investments held with external fund managers are outside the scope of the investment regulations, as they all relate to funds held by Council operated Charities or Trusts.

6.7 The Annual Property Investment Strategy for 2014/15 was also approved by the Council at its meeting on the 26 February 2014 (Report 14/77 refers) and was complied with in full, with no breaches in compliance with permitted investment limits.

6.8 The budgeted income from the Council’s property portfolio for 2014/15 was originally projected to be £1,789,000. The actual Income for the Council’s property portfolio for 2014/15 was £1,685,000, a shortfall of £104,000. This arose due to retrospective rental adjustments for the St. Johns Centre in Perth.

6.9 There were neither additional risks identified nor new property investments entered into over the year. The strategy action plan remained on programme.

7. COMPLIANCE WITH TREASURY POLICIES AND LIMITS

7.1 There were no breaches of compliance with the Council's approved lending policy in 2014/15. All aspects of the Prudential Code, including Prudential Indicators and limits, were fully adhered to throughout the year.

7.2 Also during the year, as comprehensibly detailed in the Quarterly Treasury Activity & Compliance reports, all funds remaining in Iceland relating to Glitnir were repaid during the year. This followed the participation in the currency auction run by the Icelandic Central Bank in February 2015. In addition, the outstanding action raised by Glitnir was settled in March 2015, following which there were no remaining issues relating to the deposit with Glitnir.

8. ACCOUNTS COMMISSION – BORROWING AND TREASURY MANAGEMENT IN COUNCILS

8.1 The Accounts Commission published their report "Borrowing and Treasury Management in Councils" in March 2015. A copy of the report is available in the Councillor's lounge, and can be accessed through the link Borrowing and treasury management in councils. A copy of the separate guidance and scrutiny questions for councillors is also attached at Appendix III of this report. The report was undertaken to assess the level of borrowing in Councils, whether Councils were meeting good practice in their borrowing strategies, whether Council's demonstrated affordability and sustainability and whether they had effective governance arrangements. The focus of the report is on long term borrowing to fund capital expenditure, and not short term borrowing as part of daily treasury management cash activities.

8.2 The report was based on annual borrowing and treasury management returns prepared by each Council in Scotland, together with more in-depth data collection, analysis and interviews with a small sample of authorities (not including Perth & Kinross Council).

8.3 The Accounts Commission ask that councillors and council officers consider the findings in the report, and identify where they are positioned in relation to the Accounts Commission expectations, and to then determine the actions they need to take. The separate guidance produced by the Accounts Commission includes scrutiny questions for Councillors to help in their scrutiny role.

8.4 The overall findings of the report were that Councils do adopt good practice and comply with all the relevant codes and practice and have developed their own borrowing strategies. However, there are some areas where the Accounts Commission felt that some improvements could be made. These include highlighting the strategic importance of borrowing and treasury management, analysing and reporting the affordability and sustainability of borrowing plans over the longer term (including greater analysis of Prudential Indicators) and improving the scrutiny of the borrowing and treasury management functions by providing wider training to Councillors.

8.5 This Council already analyses the impact of borrowing over the longer term (up to 30 years), including affordability and sustainability, and this information is used in modelling different capital investment scenarios. However, consideration could be given to how these could be better reported more widely. It is also proposed to organise another Treasury Management training session for elected members, as it has been several years since the last session was undertaken. It is proposed that this training session would be delivered by Capita Asset Services (the Council's treasury management advisers) and CIPFA on 6 October 2015. This would allow for more effective scrutiny, and support Councillors in undertaking this function.

9. CONCLUSION AND RECOMMENDATIONS

9.1 Economic and political uncertainties in Europe have kept UK interest rates low for several years, and led to longer term rates falling slowly over the second half of the year after a period of gradual increases. With long term rates originally forecast to increase over the year, the borrowing strategy was to undertake borrowing when rates were relatively low. This included borrowing future year's requirements given the forecast for rates. Consequently, £55M of new long term borrowing was undertaken during the year. The Council's long term debt portfolio increased over the year as a result of the amount of new borrowing exceeding maturing debt.

9.2 There was limited investment of cashflow surpluses undertaken for longer periods (up to 12 months) to take advantage of slightly higher rates. For most cashflow surpluses, shorter term fixed deposits (for 3 to 6 months), investment deposit accounts and Money Market Funds (MMF) were used in order to manage cashflow and liquidity.

9.3 There were no breaches of compliance within the lending policy during the year, and all Prudential Indicators were complied with during the year. As a result of the activities undertaken throughout 2014/15 the Council's plans remain affordable, prudent and sustainable.

9.4 It is recommended that the Committee:

1. Notes the content of this report, which is submitted in accordance with the Council's approved Treasury Management Practices (TMPs).

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Approved

Name	Designation	Date
John Symon	**Head of Finance**	**15 June 2015**

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ANNEX

1. IMPLICATIONS, ASSESSMENTS, CONSULTATION AND COMMUNICATION

Strategic Implications	**Yes / None**
Community Plan / Single Outcome Agreement	None
Corporate Plan	Yes
Resource Implications	
Financial	Yes
Workforce	Yes
Asset Management (land, property, IST)	Yes
Assessments	
Equality Impact Assessment	Yes
Strategic Environmental Assessment	Yes
Sustainability (community, economic, environmental)	Yes
Legal and Governance	None
Risk	None
Consultation	
Internal	Yes
External	Yes
Communication	
Communications Plan	None

1. Strategic Implications

1.1. <u>Corporate Plan</u>

1.1.1. The Council's Corporate Plan 2013 – 2018 lays out five outcome focussed strategic objectives which provide clear strategic direction, inform decisions at a corporate and service level and shape resources allocation. They are as follows:

(i) Giving every child the best start in life;
(ii) Developing educated, responsible and informed citizens;
(iii) Promoting a prosperous, inclusive and sustainable economy;
(iv) Supporting people to lead independent, healthy and active lives; and
(v) Creating a safe and sustainable place for future generations.

1.1.2 This report relates to all of these objectives.

2. Resource Implications

2.1. <u>Financial</u>

2.1.1. There are no direct financial implications arising from this report other than those reported within the body of the main report.

2.2. Workforce

2.2.1. There are no direct workforce implications arising from this report other than those reported within the body of the main report.

2.3. Asset Management (land, property, IT)

2.3.1. There are no direct asset management implications arising from this report other than those reported within the body of the main report.

3. Assessments

3.1. Equality Impact Assessment

3.1.1. Under the Equality Act 2010, the Council is required to eliminate discrimination, advance equality of opportunity, and foster good relations between equality groups. Carrying out Equality Impact Assessments for plans and policies allows the Council to demonstrate that it is meeting these duties.

3.1.2. The information contained within this report has been considered under the Corporate Equalities Impact Assessment process (EqIA) and has been assessed as **not relevant** for the purposes of EqIA.

3.2 Strategic Environmental Assessment

3.2.1 The Environmental Assessment (Scotland) Act 2005 places a duty on the Council to identify and assess the environmental consequences of its proposals.

3.2.2 The information contained within this report has been considered under the Act. However, no action is required as the Act does not apply to the matters presented in this report.

3.3 Sustainability

3.3.1 Under the provisions of the Local Government in Scotland Act 2003 the Council has to discharge its duties in a way which contributes to the achievement of sustainable development. In terms of the Climate Change Act, the Council has a general duty to demonstrate its commitment to sustainability and the community, environmental and economic impacts of its actions.

3.3.2 The information contained within this report has been considered under the Act. However, no action is required as the Act does not apply to the matters presented in this report.

4. Consultation

4.1 The Chief Executive, and the Council's Treasury advisors, Capita Asset Services, have been consulted in the preparation of this report.

5. BACKGROUND PAPERS

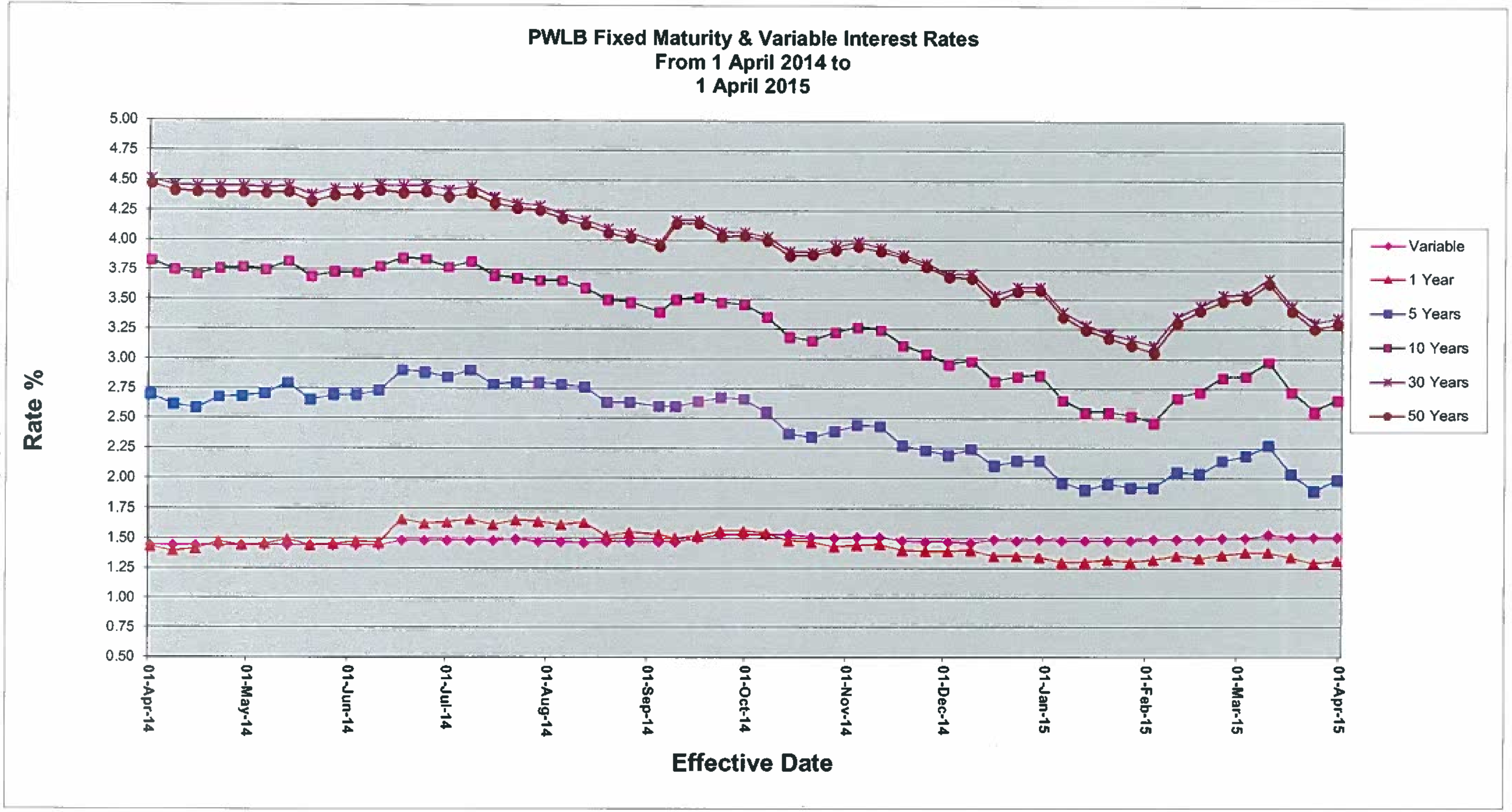
5.1 No background papers, as defined by Section 50D of the Local Government (Scotland) Act 1973 (other than any containing confidential or exempt information) were relied on to any material extent in preparing the above report.

6. APPENDICES

Appendix I – PWLB Fixed Maturity & Variable Interest Rates From 1 April 2014 to 1st April 2015.

Appendix II – Average Loans Fund Rates.

Appendix III – The Accounts Commission Borrowing and treasury management in Councils supplement (scrutiny guidance and questions for councillors)


PWLB Fixed Maturity & Variable Interest Rates
From 1 April 2014 to
1 April 2015
Rate %
5.00
4.75
4.50
4.25
4.00
3.75
3.50
3.25
3.00
2.75
2.50
2.25
2.00
1.75
1.50
1.25
1.00
0.75
0.50
01-Apr-14
01-May-14
01-Jun-14
01-Jul-14
01-Aug-14
01-Sep-14
01-Oct-14
01-Nov-14
01-Dec-14
01-Jan-15
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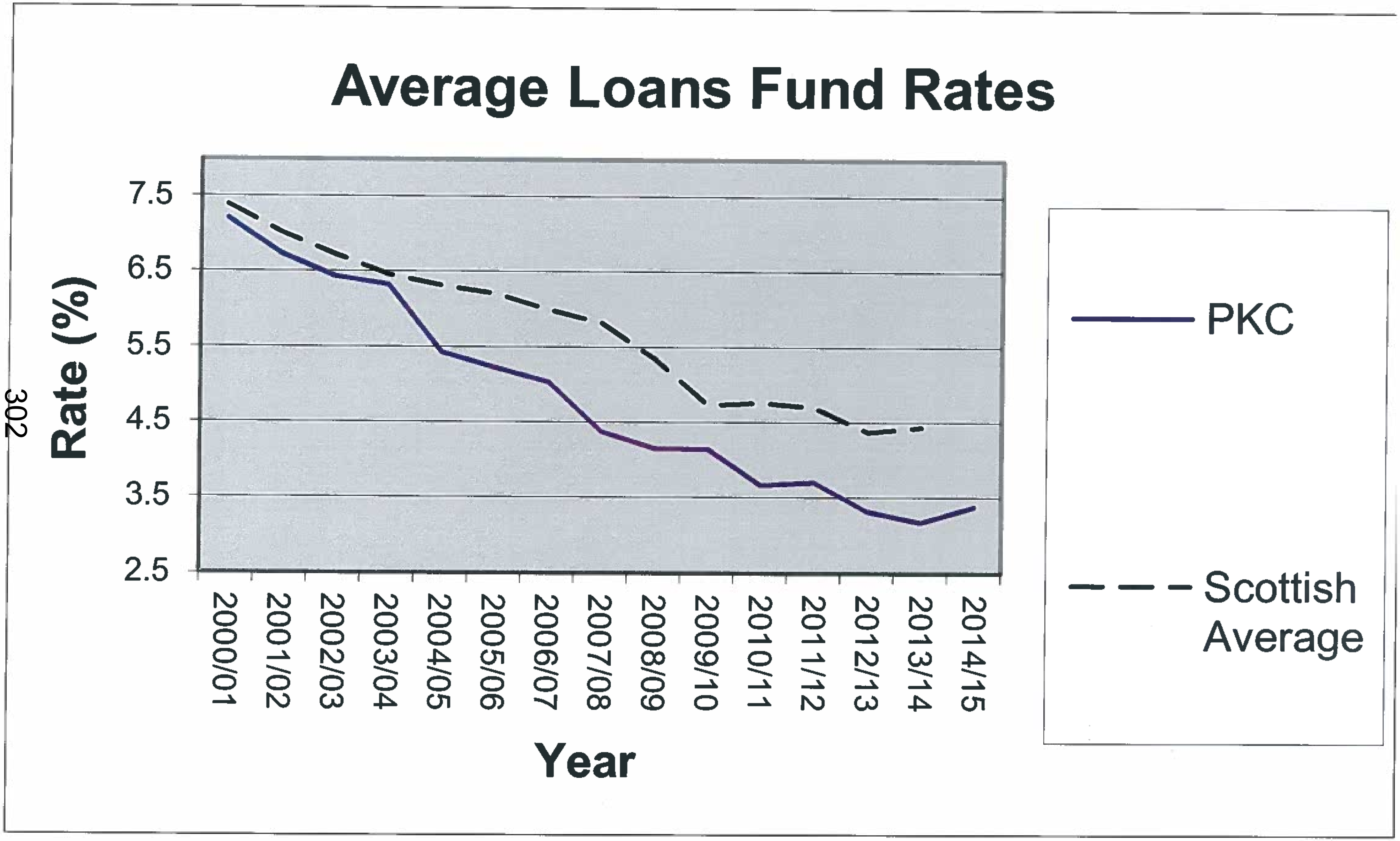
01-Mar-15
01-Apr-15
Effective Date
Variable
1 Year
5 Years
10 Years
30 Years
50 Years


Average Loans Fund Rates
Rate (%)
7.5
6.5
5.5
4.5
3.5
2.5
2000/01
2001/02
2002/03
2003/04
2004/05
2005/06
2006/07
2007/08
2008/09
2009/10
2010/11
2011/12
2012/13
2013/14
2014/15
Year
PKC
Scottish Average

SUPPLEMENT

Prepared by Audit Scotland | March 2015

Borrowing and treasury management in councils

Scrutiny guidance and questions for councillors

ACCOUNTS COMMISSION

About the audit

1. Our audit 'Borrowing and treasury management in councils' assessed how councils show best value in borrowing and treasury management decisions. Its specific objectives were to answer:

- What is borrowing and treasury management in councils?
- To what extent do councils' borrowing and treasury management strategies meet good practice and contribute to corporate plans and priorities?
- Can councils demonstrate the affordability and sustainability of borrowing decisions? For example can they show that borrowing will not adversely affect their financial position? Will that continue to be the case in future?
- How effective are the governance arrangements for borrowing and treasury management? Governance covers areas such as responsibility and accountability for borrowing and treasury management decisions, arrangements for reporting decisions and for scrutinising them.

Purpose of the scrutiny guidance and questions

2. We have developed this guidance to assist councillors in their borrowing and treasury management scrutiny role. Councillors have important responsibilities to ensure that the appropriate level of scrutiny is given to decisions made by council officers.

3. This guidance is intended to be used by councillors as an aide when scrutinising borrowing and treasury management reports and activity. It suggests potential questions that can be asked of council officers. It also outlines the reasons why these questions are important and what type of response should be expected. The suggested questions are for the following areas:

- treasury management strategies and related reports
- borrowing and other financial decisions
- affordability and sustainability
- performance and benchmarking.

4. This guidance is in three parts. Part 1 sets the scene and provides some background to borrowing and treasury management. Part 2 highlights the key responsibilities councillors have in relation to borrowing and treasury management. It also highlights the key scrutiny findings from our audit report. Part 3 contains some questions councillors can use when scrutinising borrowing and treasury management reports and activity.

Part 1

Setting the scene

Councils invest in services for communities

5. A council has a corporate plan setting out its priorities and objectives and how it plans to achieve them (Exhibit 1, page 4) This may, for example, include the priority to build a new school to deal with an expected increase in demand as a result of significant new housing. These plans are often over the medium term, typically three to five years, but may be over a longer term, ie up to 15 years. The council targets its resources, that is people, money and assets, at its priorities and objectives. The corporate plan should feed into the asset management plan to identify what assets are needed to achieve its objectives. For example, this could be building new housing. The council, through a capital investment plan, sets out how it will finance the spending on these assets. This may be by using cash resources, for example cash reserves built up over time or capital grants, or through external finance.

6. Methods of external finance include borrowing, Public Finance Initiative schemes and other mechanisms including Non Profit Distributing schemes, Tax Incremental Financing schemes, or the new Growth Accelerator Model. Entering into external financing arrangements will create debt for the council, and means that the council needs to pay financing charges each year over the life of the arrangement, which may be up to 50 years. It is important for a council to assess the affordability of decisions in the context of the financing charges of its total debt.

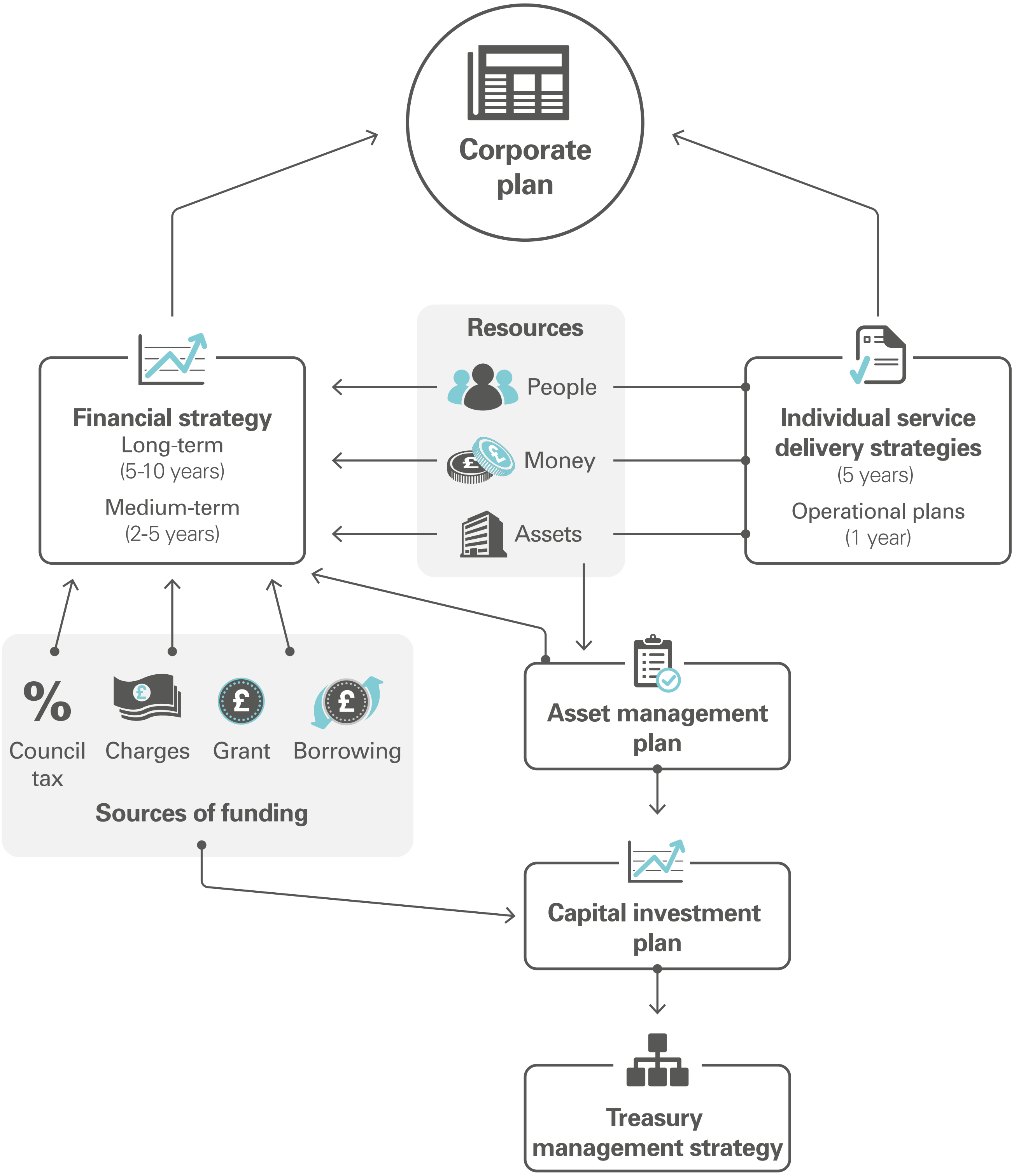
7. Councils should also have medium (two to five year) and long-term (five to ten year) financial strategies. The council will estimate future funding and income, costs and demand for services, and how much it will need to spend to achieve its future objectives. The strategy should identify how the council will make up any shortfall between estimated funding and projected costs and demand. The financial strategy should include the financing cost of borrowing and other debt. This is the annual repayment of interest charged on borrowing or other external financing and any other associated costs. Councils make this repayment out of future budgets, so it decreases the level of available budget remaining and reduces flexibility in future budget decisions.

8. Borrowing involves accessing finance and then repaying it over a longer period of time. These periods can be for up to 50 years, so today's decisions can have a sustained impact on future generations. Borrowing decisions involve a careful balancing act between prioritising investment, and making sure the council can:

- manage the consequences of its decisions over the whole life of the borrowing
- provide evidence showing how it will manage these long-term consequences.

9. Borrowing therefore is set firmly within the framework of wider council activity and should be driven by the corporate plan, capital investment plan and medium and long-term financial strategies (Exhibit 1, page 4).

Exhibit 1
Corporate and strategic influences on treasury management strategy



Source: Audit Scotland

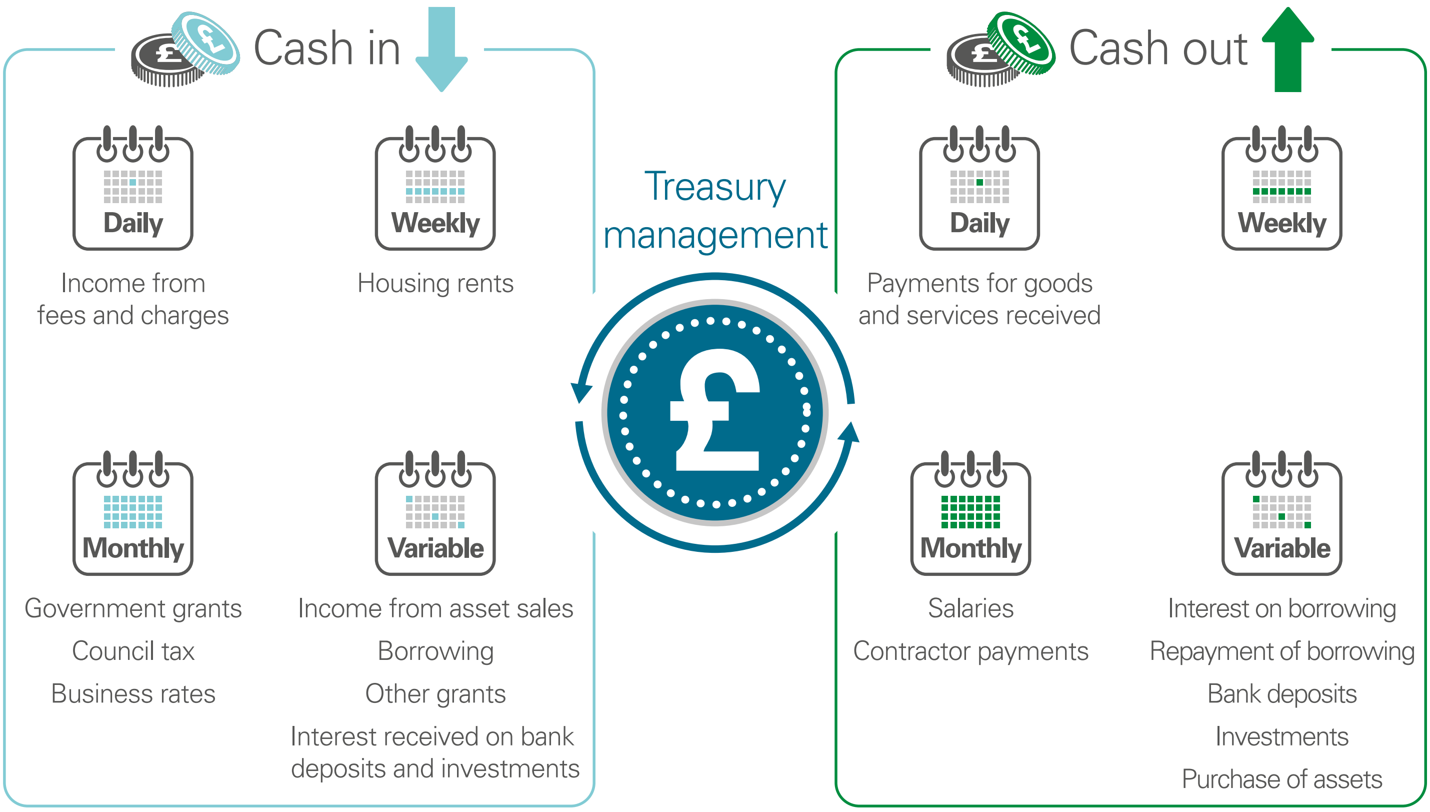
Borrowing is a key part of treasury management

10. Treasury management is the process that councils use to ensure cash is available when needed. This includes day-to-day expenses like paying salaries or electricity bills, and building new assets, such as a new school, or improving existing ones, such as roads. It also involves ensuring that any temporary surplus cash is safely invested. Borrowing is one of the larger cash flows that a council needs to manage, so borrowing is a central part of treasury management. Exhibit 2 shows examples of the typical cash flows in a council together with their timing.

Exhibit 2

Treasury management activities

An example of a council's cash flows with their timing to demonstrate their variability and predictability.



Source: Audit Scotland

11. Councils have two types of budgets to finance and to balance: revenue and capital. Revenue expenditure pays for daily activities like salaries or electricity bills. Capital expenditure is what councils spend on premises, equipment and vehicles; on improvements like roads repairs; and on providing new assets like schools or council houses. Councils can borrow to finance capital expenditure but not revenue expenditure, unless approved by Scottish Ministers. Borrowing charges are revenue expenditure. Councils that own council houses must keep a separate budget and account for revenue and capital expenditure on the housing stock. Borrowing to invest in housing must be repaid from the future housing budget, and therefore funded from future housing rental income.

Councils must comply with borrowing and treasury management rules and regulations

12. In recognition of the importance of capital investment in assets and treasury management to council activities, CIPFA and the Scottish Government set codes of practice and regulations for councils to follow. These ensure that councils have effective processes and practice in place to control, manage and govern capital investment decisions, that include borrowing, and treasury management practices (Exhibit 3).

13. The Prudential Code was introduced in 2004 as a framework to support councils and help them show effective control over levels of, and decisions relating to, capital investment activity, including borrowing. Before this, capital investment levels in councils were government-regulated.

14. This self-regulating approach has enabled councils to adopt borrowing and treasury management strategies that fit with their corporate plans and objectives. The framework allows for councils themselves to judge what is affordable and sustainable and will differ depending on local circumstances. The Prudential Code sits alongside CIPFA's treasury management code, which sets out the requirements for professional treasury management practice.

Exhibit 3
Codes of Practice and Regulations

The Prudential Code for Capital Finance in Local Authorities-CIPFA	A professional code of practice to help councils with capital investment decisions by providing a framework. The Prudential Code sets out indicators that councils must use to help demonstrate public accountability. It also recommends that councils have an integrated treasury management strategy within which its borrowing and investments are managed.
Treasury management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes-CIPFA ('the CIPFA treasury management code')	Adopting this code is a requirement of the Prudential Code. This makes recommendations to provide a basis for councils to create clear treasury management objectives and to structure and maintain sound treasury management policies and practices. A key recommendation is for a treasury management strategy before the start of the year, a mid-year report and an end-year review report.
Finance Circular 5/2010-The investment of money by Scottish local authorities	Provides Scottish ministers' consent for councils investing money and sets out the recommendations and requirements they must meet when making investments. It requires local authorities to 'have regard' to the Prudential Code and the Treasury Management Code and recommends that the strategy form part of a wider single annual strategy covering capital investment, treasury management and prudential information.
Local Government (Scotland) Act 1975	Sets out the statutory basis on which councils can borrow and lend.

Source: Audit Scotland

15. A key requirement of the codes is for councils to produce an annual treasury management strategy before the start of each financial year. CIPFA and the Scottish Government recommend that this is a single integrated strategy that combines plans for capital investment, including borrowing, treasury management, and investment. It also recommends that the strategy includes prudential indicators that are set out within the Prudential Code. These form a set of a 12 limits and ratios that all councils must calculate and use to show to councillors and the public that capital investment plans are affordable and sustainable.

16. Our audit report focused on borrowing, to finance capital investment, and treasury management. Most of the indicators are not specific to borrowing but relate to total capital investment and are calculated using figures for total finance costs, total capital expenditure or total debt. This allows councils to assess the affordability of borrowing in the context of the total debt position of the council. The indicators relating specifically to borrowing are the estimated and actual capital financing requirement. This calculates the amount of capital investment that needs to be met from borrowing or other method of external finance.

17. The prudential indicators are designed to help councils make and record local decisions. They are not designed to be comparative performance indicators across councils as they are set according to the individual needs of each council. In particular, councils had widely different debt positions when the Prudential Code was introduced. These differences are likely to increase over time as councils' choices reflect local priorities. The system is designed specifically to help councils take local decisions in ways that are publicly accountable.

Part 2

Scrutiny responsibilities and report findings

Councillor scrutiny responsibilities

18. Councillors have a key role in holding officers to account. Borrowing and treasury management decisions are complex and involve a significant level of financial risk. It is essential that any decisions are effectively scrutinised to demonstrate sound financial management and help councils achieve their local outcomes and priorities.

19. The main ways in which councillors do this is by scrutinising and approving borrowing and treasury management strategies and reports. Council officers are required to produce an annual treasury management strategy prior to the start of each financial year, which needs to be approved by full council. Councillors should also be presented with a mid-term and year-end report which monitors the progress made against the annual strategy.

20. Prior to approval by full council, these reports should be scrutinised by an appropriate scrutiny committee. Councils' scrutiny committees are a vital part of a council's governance arrangements and it is important that these committees are effective. Councillors on committees need to have a combination of technical knowledge and scrutiny skills for the committee to be most effective.

21. The codes of practice and regulations place certain requirements on a council's governance structure. CIPFA suggest the below allocation of duties and responsibilities for those involved in approving and scrutinising borrowing and treasury management activities (Exhibit 4).

Exhibit 4
Allocation of responsibilities for scrutinising borrowing and treasury management activities

Full council	• Receives and reviews reports on treasury management policies, practices and activities • Approves annual strategy
Committee or panel with responsibility for scrutiny	• Approves or amends the organisation's treasury management policy statement and treasury management practices • Considers and approves budget • Approves the division of responsibilities • Receives and reviews regular monitoring reports and acts on recommendations • Approves the selection of external service providers and agrees terms of appointment • Reviews the treasury management policy and procedures and makes recommendations to the responsible body
The responsible officer	• Monitors the council's compliance with policy and practices • Submits regular treasury management policy reports • Submits budgets and budget variations • Recommends the appointment of external service providers

Source: Audit Scotland

22. There is a responsibility placed on council officers to ensure that councillors are enabled to provide effective scrutiny. This includes ensuring that information provided to councillors is clear and understandable. Officers should also ensure that councillors are aware of the wider impact that borrowing and treasury management decisions can have.

23. Councillors charged with governance have a personal responsibility to ensure that they have the appropriate skills and training for their role. Council officers are responsible for ensuring that councillors have the required level of technical knowledge and scrutiny skills. This is done through providing training to councillors as and when required, which is often part of the induction process at the start of a political term.

Audit findings

24. Our audit report found that councils need to improve scrutiny of borrowing and treasury management. As this is a complex and technical subject, officers need to provide councillors with access to the skills and knowledge they need to carry our their role effectively. The audit report found that current governance structures in some councils could be improved to support more effective scrutiny.

25. We found that some councils use additional scrutiny arrangements in this area. This included using non-executive appointments to provide financial expertise and nominating a lead member on the scrutiny committee for finance. Councillors asked a range of scrutiny questions, from issues of detail to questions of clarification, and all councillors we spoke to would welcome additional support.

26. The layout and content of reports could be improved. In year-end reports, performance monitoring is not reported fully and consistently across councils. Some councils do not provide any comparative data, which makes it difficult to reach an objective opinion on performance. Officers must use accessible language in reports. Many of the strategies and reports we reviewed contained technical language, which does not enable effective scrutiny.

27. Councils do provide both scrutiny training and treasury management training to councillors. Attendance at training sessions is generally poor, but councillors who did attend had positive views. However, some councillors told us that they are not always confident in challenging the strategy or reports. Training and support should equip all councillors with a minimum level of knowledge and understanding. Councillors noted it was often difficult to attend training owing to other commitments.

Audit recommendations for improved scrutiny

Council officers should:

- use the treasury management strategy to present a wider strategic view of borrowing and treasury management. It should use clear and accessible language and be prepared for councillors as the key audience. It should include how the borrowing strategy is informed by corporate priorities and capital investment needs. The strategy should include:
  - links to capital investment plans and corporate objectives
  - all borrowing and other debt
  - prudential indicators as a core part of the strategy
  - a clear assessment of the affordability and the impact on revenue budgets both in the short and long term
- review the content of year-end reports to ensure they provide an assessment of the effectiveness of the year's borrowing and treasury management activities and the performance of the treasury management function. This should include appropriate indicators, comparative figures, and appropriate explanations.

Council officers and councillors involved in treasury management should:

- review governance arrangements, and update as necessary, to ensure they provide:
  - the treasury management strategy, mid-year and year-end reports to the same council committee, and that the full council has access to them
  - councillors with mid-year reports by the end of December each year
  - councillors with the wider picture, that is, make the links to capital investment decisions and revenue budgets
  - councillors with access to all reports relating to borrowing and treasury management activity including risk registers
- ensure scrutiny arrangements are robust by:
  - considering widening the range of training options to councillors on borrowing and treasury management activities and whether this training should be mandatory
  - considering whether training for councillrs provides a balance of scrutiny skills and knowledge of treasury management.

Part 3

Scrutiny checklist for councillors

Questions for councillors on borrowing and treasury management

Question	Why should I ask this?	What do I expect to see/hear in the response from officers?
Treasury management strategy and related reports		
Do the contents of the treasury management strategy and related reports include all recommendations in the CIPFA codes?	The CIPFA codes are best practice guidance and councils should be meeting the guidance. Only in exceptional circumstances should councils not be following the guidance.	Officers should provide assurance that reports meet all recommendations but will highlight any departures from the code with an explanation why.
Do the contents of the treasury management strategy reflect the wider picture of how we plan to meet our capital commitments?	CIPFA's Prudential Code helps councils demonstrate good capital investment decisions. The treasury management strategy reflects how these decisions impact on treasury management activity. Our expectation is that the strategy is self-explanatory.	Minimal additional explanation should be required from officers to explain the wider context.
Borrowing and other financing decisions		
Is the proposed borrowing option the best option for the council?	Other viable financing options may be available. Officers should be considering all options and appraising these.	Officers can explain the other options that they have considered. Officers should be able to demonstrate that they have considered different scenarios. The treasury management strategy should reflect on the options that have been considered and include links to further information.

Cont.

Question	Why should I ask this?	What do I expect to see/hear in the response from officers?
What would affect the decision and how will I be informed if the situation changes?	Economic circumstances, such as interest rates, may change throughout the year that will affect decisions. As a councillor you should expect officers to keep you updated on significant changes in circumstances that will affect treasury management decisions.	Officers may be able to offer briefings or updates in these circumstances.
What are the risks?	Treasury management risks should be identified within the appropriate council risk register. In making or approving decisions you need to be aware of the potential risks and how likely they are to emerge. New financing options may have additional or different risks to traditional borrowing.	Officers should: • outline how they identify, monitor and act on treasury management risks • identify and discuss the risks and the likelihood of them occurring • refer to other treasury management risk registers and reports.
Have we received any external advice?	It may be helpful to seek external advice, particularly on new financing options.	Officers should explain the nature of any advice they received and whether or not they took it.
What are other councils doing?	Councils have policies in place, have different circumstances and have to do what is right for them but knowing what other councils are doing can provide assurance on your own decisions.	Officers should: • know whether there are any councils with similar circumstances and draw comparisons • be aware of other councils' borrowing patterns and where they are borrowing from • be aware of new financing options and whether other councils are using them, and their experience of using them.

Cont.

Question	Why should I ask this?	What do I expect to see/hear in the response from officers?
Affordability and sustainability		
Is the borrowing and finance affordable?	Decisions will impact on current and future budgets when finances are already tight.	Officers should: • detail the costs of different options and scenarios • detail the impact of the preferred option on the revenue budget.
What is our current maturity profile for our borrowing?	Borrowing decisions made today have a long-term impact on revenue budgets. The maturity profile shows the future impact of past and current borrowing decisions. It will highlight future periods of demand on the revenue budget. Councils should be trying to 'smooth' their maturity profile, that is, try to ensure as even a spread of debt and demand on the revenue budget as possible.	A chart of maturity dates is usually easier to interpret. Officers will be able to identify future periods of potential financial pressure from the charts. Officers can explain what steps are being taken now to ensure the financial resources are in place in future. Officers can also explain how decisions to borrow will affect the future profile.
How does our profile compare to other councils?	This can highlight whether the council will face similar pressures to others. It is useful for drawing on the experience of other councils.	A chart comparing the council's profiles with others will highlight similarities and differences. Officers can explain similarities with other councils and may be able to explain how other councils plan to deal with similar financial pressures.
What other debt do we have? (Examples include: PPP/PFI, NPD and TIFs)	Commitments to borrow shouldn't be taken in isolation. Other debt has a long-term financial impact.	The treasury management strategy should set out all of the council's existing liabilities. The strategy should indicate the financial commitments and include a link to the detail.
Are we liable for the debt of ALEOs or other external bodies?	Effective risk management includes identifying and monitoring potential financial commitments.	The treasury management strategy should include the nature of debt with ALEOs or other external bodies. Officers should be able to identify debts, what the relationships are, what the nature of the potential debt is and the likelihood of it occurring. Officers should be able to refer to a risk assessment.

Cont.

Question	Why should I ask this?	What do I expect to see/hear in the response from officers?
Performance and benchmarking		
What do the prudential indicators tell me?	The indicators use technical terms and are based on figures from the financial statements. They can indicate an increasing proportion of spend on debt repayments and when things are becoming less affordable. It is useful to compare trends year-on-year. There is the potential for comparing trends and patterns with other councils although the indicators are meant to be used by councils individually.	The treasury management strategy should explain, in layman's terms, what the indicators mean. Officers should provide further explanation or clarification. Although indicators are for the use of individual councils, officers may be able to draw trend comparisons with other councils. Officers should explain any action they have taken or plan to take in relation to the indicators.
Is 'under-borrowing' a good thing? What does this mean in practice?	'Under-borrowing' means the council did not need to borrow up to the level of the estimated capital financing requirement. 'Under borrowing' is usually seen as positive but can be a sign of other issues, such as, not accurately identifying the borrowing requirement or slippage in the capital programme.	Officers should explain why this happened, for example, additional money from capital receipts meant the reduced need to borrow less.
Do we have other performance measures?	The Prudential Code sets out the minimum requirements for performance reporting. Councils can introduce other performance measures.	Officers should be able to explain the purpose, details and any necessary remedial action in relation the performance measure.
What do our advisors cost and what do we get for this?	There are very few advisors in the market. The council needs to: • ensure that a thorough and impartial appointment process is in place • have assurance that advice is tailored to the individual authority • ensure that officers ultimately take the decisions.	Officers should provide details of: • the tendering process for appointing the advisors • the cost and terms of the contract, including what services the advisors will provide • examples of advice not taken and why.

Cont.

Question	Why should I ask this?	What do I expect to see/hear in the response from officers?
Do we have the treasury management skills that we need?	This is a very technical area that requires suitably skilled and trained staff. CIPFA treasury management qualification is no longer available. It is important to have succession planning: that is, what arrangements are in place if treasury management staff leave.	Officers should be able to: • detail the cost, number of staff and skills/qualifications of those involved in treasury management • justify current staffing requirements • detail future staff needs or training requirements and how they will be met.