Report to:	**Audit , Best Value and Community Services Scrutiny Committee**
Date:	**1 September 2011**
By:	**Director of Corporate Resources**
Title of report:	**Treasury Management – Stewardship Report 2010/11**
Purpose of report:	**To present a review of Treasury Management activity**

RECOMMENDATION: The Audit, Best Value and Community Services Scrutiny Committee is asked to consider the presentation on Treasury Management and, in the context of the Annual Stewardship report and to note the Treasury Management performance in 2010/11

1. Financial Appraisal

1.1 The Annual Stewardship report reviews the Council's Treasury Management performance and is required by the code of Practice for Treasury Management.

2. Supporting Information

2.1 At its meeting on 1 June 2011, the Committee resolved to defer consideration of Treasury Management performance in 2010/11 to a future meeting. The opportunity is now being taken to give presentation to Members on Treasury Management activities in general and a copy of that presentation is attached at Appendix 1. Appendix 2 sets out the operating framework for Treasury Management within which local authorities must operate and a copy of the report to the 1 June meeting is attached at Appendix 3.

3. Conclusion and reason for recommendation

3.1 This report updates the Audit and Best Value Scrutiny Committee on Treasury Management activities and Treasury Management performance in 2010/11.

SEAN NOLAN
Director of Corporate Resources

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Local Members: All

<u>Background Documents</u>

Cabinet 26 January 2010 Treasury Management Strategy for 2010/11
8 June 2010 Treasury Management Stewardship Report 2009/10
16 November 2010 Treasury Management – Half year review 2010/11
25 January 2011 Treasury Management Strategy for 2011/12
5 July 2011 Treasury Management Stewardship Report 2010/11
CIPFA Prudential Code and Treasury Management in the Public Services- Code of practice
Local Government Act 2003

Presentation to Audit and Best Value Scrutiny Committee- September 2011

Treasury Management

Amanda Walker

Deputy Director, Finance

What are Treasury Management activities?

"The management of the organisation'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"

CIPFA Treasury Management Code of Practice

Operating Framework – (Please See Appendix 1)

1. Local Government Act 2003
2. Statutory Instrument (SI) 3146/2003
3. CIPFA Treasury Management Code of Practice
4. Section 151 Local Government Act 1972

Economic Environment

1. Global Financial Turmoil
2. Eurozone / US
3. Credit Ratings

Credit Ratings – (Please See Appendix 2)

Managing Risk – Credit Ratings

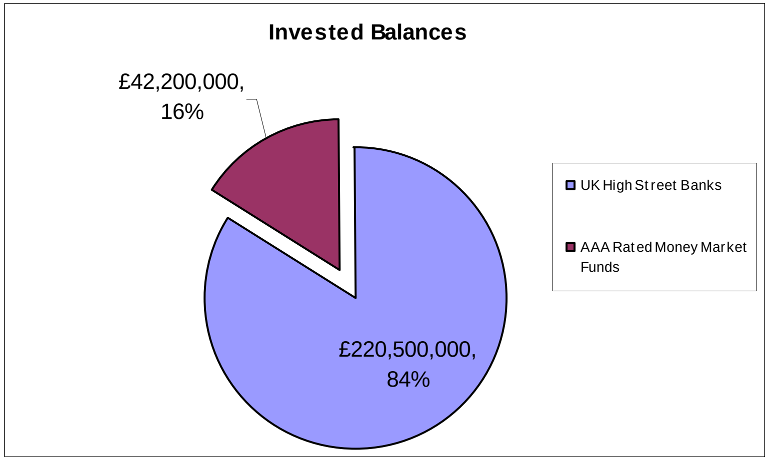
- What is a Credit Rating?
- The Three Credit Rating Agencies
- Rating Criteria

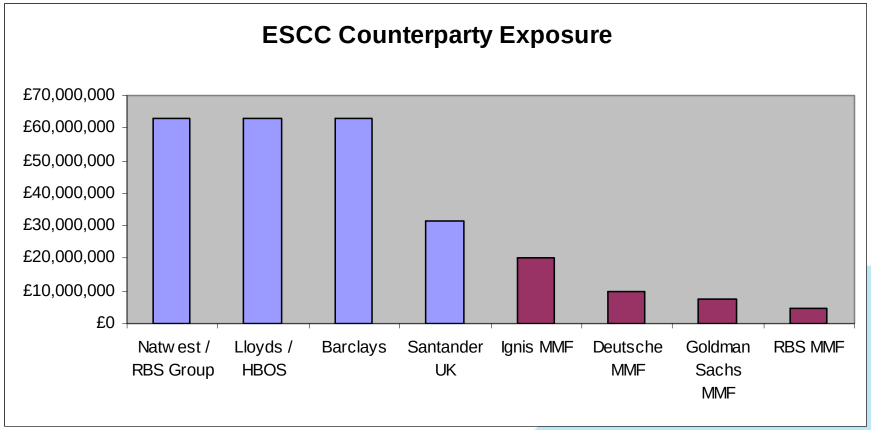
Equivalent Ratings

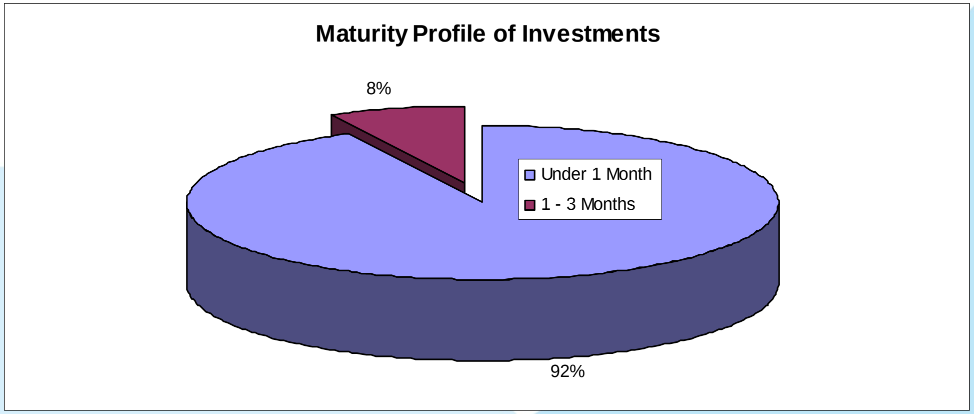
Fitch		Moody's		Standard & Poor's		
Short Term	**Long Term**	**Short Term**	**Long Term**	**Short Term**	**Long Term**	
F1+	AAA	P-1	Aaa	A-1+	AAA	
	AA+		Aa1		AA+	
	AA		Aa2		AA	
	AA-		Aa3		AA-	Acceptable
F1	A+	A+	A1	A-1	A+	Not Acceptable
	A	P-2	A2 A2		A	
	A-		A3 A3	A-2	A-	
			Baa1		BBB+	
			Baa2			

East Sussex County Council

Investments (Lending) as at July 2011 - £263m







East Sussex County Council

Managing Risk – (Please See Appendix 3)

- Clear policy, regular review
- Trained staff
- Active S151 officer involvement
- Visibility – strategy and stewardship
- Internal and External Audit and Scrutiny
- External Treasury Management Advisors (Sector)
- Local Authority Treasury Management Network

How do we measure up?

<u>Conforming with best practice</u>

- Internal audit response
  Full Assurance 2010/11

- CIPFA Codes of Practice
  Full Compliance

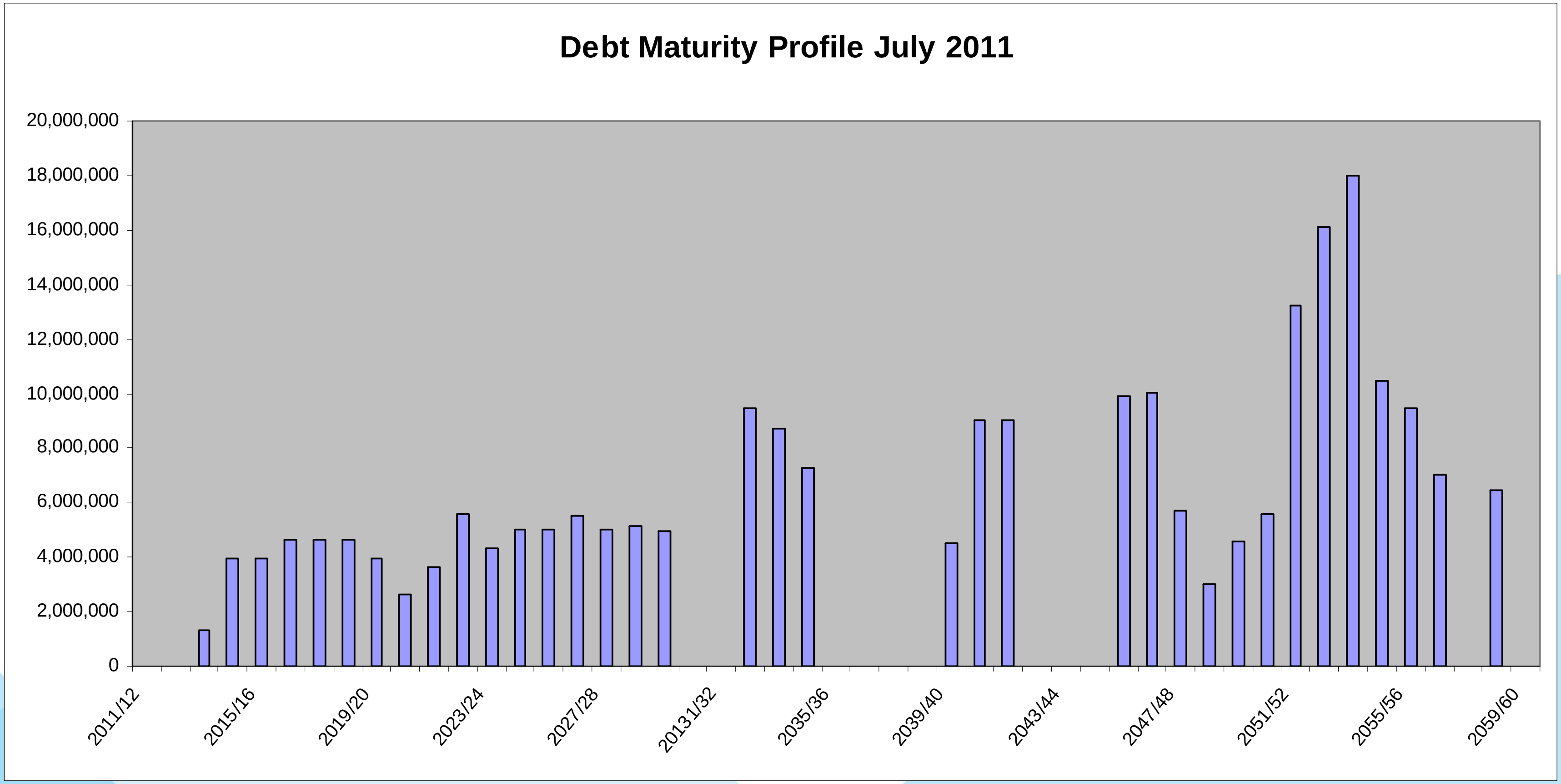
<u>Performance 2010/11</u>

- Bank of England base rate 0.50% (since March 2009)

- Investment (lending) average rate of 0.94% earned

- Borrowing (debt) average rate of 5.31% paid

Borrowing (Debt) - £241m



Frequently Asked Questions

Appendix 2 Operating Framework

1: Local Government Act 2003

The framework of treasury management within which local authorities must operate is made up of various pieces of legislation, guidance and best practice. Until 2004, local authorities had to invest in a Government-approved list of banks and other bodies (known as 'counterparties'), a system described by Rt Hon John Healey, Minister for Local Government, as "inflexible, … unwelcome, and ultimately … ineffective."

Despite the fact that the list was 'government approved', it was still possible for councils to lose money: most memorably in the case of the Western Isles Council, when one bank on the approved list—the Bank of Credit and Commerce International (BCCI)—collapsed in 1991. The collapse of BCCI prompted the then Treasury and Civil Service Select Committee to publish a Report which highlighted the essential principle which should guide local authority treasury management: "In balancing risk against return, local authorities should be more concerned to avoid risks than to maximise returns."

The Government decided that a more flexible system with less detailed regulation was required. From 2004, therefore, a new system of local government capital control was introduced, including new arrangements that allowed councils greater freedom to make their own decisions about where to lend money. That system has its statutory basis in the Local Government Act 2003. This Act gives local authorities a clear power to invest "(a) for any purpose relevant to its functions under any enactment, or (b) for the purposes of the prudent management of its financial affairs", requiring local authorities to self-regulate their capital finance, borrowing and investment activities.

2: Statutory Instrument (SI) 3146/2003

The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003—develops the controls and powers in the Act and requires local authorities to have regard to the CIPFA Prudential Code for Capital Finance.

The Office of the Deputy Prime Minister's informal commentary on its formal statutory guidance under Section 15(1)(a) of the Local Government Act 2003 states that:

the general policy objective is that local authorities should invest prudently the surplus funds held on behalf of their communities. The [formal statutory] guidance recommends that priority should be given to security and liquidity. However, that does not mean that authorities should ignore yield. It will be appropriate to seek the highest rate of return consistent with the proper levels of security and liquidity.

According to the Government guidance, the core principles that local authorities should follow when investing money are:

- to make the deposits secure,
- to ensure they have sufficient liquidity for their daily demands,
- finally, to produce the highest available yield, once the first two considerations have been met.

The security of investments is ascertained by the assessment and management of the risk involved. The guidance also stipulates that local authorities must have regard to the Treasury Management (TM) Code of Practice, published by the Chartered Institute of Public Finance and Accountancy (CIPFA).

3: CIPFA Treasury Management Code of Practice

The Chartered Institute of Public Finance and Accountancy (CIPFA) is one of the leading professional accountancy bodies in the UK and the only one that specialises in the public services. It publishes the Treasury Management (TM) Code of Practice, which is given legislative weight by the 2003 Act. Subsequent to the Act, CIPFA published a Prudential Code for Capital Finance in Local Authorities and also updated and revised the guidance notes that complement the TM Code of Practice.

The Treasury Management Code of Practice

The Treasury Management Code of Practice is described by CIPFA in its written evidence as follows:

The Code sets out the procedure and policies local authorities should follow in the organization and operation of their treasury management functions.

The Code makes three recommendations for the adoption of policies and practices to secure local authorities' best practice in treasury management:

- To put in place formal and comprehensive objectives, policies and practices, strategies and reporting arrangements to ensure the effective management and control of TM activities.

- To demonstrate thorough policies and practices that effective management and control of risk are prime objectives of TM activities.
- To acknowledge that the pursuit of best value in TM, and the use of suitable performance measures, are important in order to secure business and service objectives, and that within the context of effective risk management, TM policies and practices should reflect this.

In order to achieve these three recommendations there are, according to CIPFA, specific practices that local authorities should adopt, including the creation of a TM policy statement; the setting up of reporting procedures, including an annual strategy; the delegation of responsibility for execution of decisions to a responsible officer; and the delegation of responsibility for the monitoring of its TM policies and practices to a relevant committee of the authority.

<u>The Prudential Code for Capital Finance</u>

The Prudential Code sets out the framework within which local authorities manage their investment requirements, as established by the Local Government Act 2003. Its key objectives are:

To ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable—or, in exceptional cases, to demonstrate that there is a danger of not ensuring this, so that the local authority concerned can take timely remedial action.

The Prudential Code requires the full Council to set certain limits on the level and type of borrowing before the start of

the financial year and gives directions for the setting up of "prudential indicators", against which local authorities can monitor and measure their performance. The first such indicator in the Prudential Code is the adoption of the CIPFA Treasury Management Code of Practice. According to CIPFA's written memorandum, if these prudential indicators are implemented, local authorities' treasury management decisions should be "affordable, prudent and sustainable".

Annual Investment Strategy (AIS)

The CIPFA TM Code of Practice recommends that the local authority receive reports on its treasury management policies and activities, including, as a minimum, an annual strategy. The updated guidance notes to the TM Code, "Treasury Management in the Public Services: Guidance Notes for Local Authorities including Police Authorities and Fire Authorities", place greater emphasis on the Annual Investment Strategy, which is central to the ODPM guidance on the 2003 Act. The CIPFA guidance notes stress that the AIS should state the local authority's policy on the use of credit ratings, the procedures for determining and limiting the use of riskier (non-specified) investments and the liquidity of investments. The AIS must be approved and, if necessary, amended by the full council, and should be publicly available.

4: Section 151 Local Government Act 1972

Local authorities are required under Section 151 of the Local Government Act 1972 to appoint an officer who is responsible for the proper administration of their financial affairs. He or she is often referred to as the Section 151 Officer and is responsible for, amongst other things, treasury management.

Scrutiny of treasury management by elected officials
The Section 151 Officer must report to the Audit Committee on the council's Treasury Management Performance for the previous year, and on its Treasury Management Strategy and Policy, including the annual investment strategy, for the following year. The Treasury Management Code of Practice recommends in Treasury Management Practice (TMP) 6 that local authorities adopt the following statement:

This organisation will ensure that regular reports are prepared and considered on the implementation of its treasury management polices; on the effects of decisions taken and transactions executed in pursuit of those policies; on the implications of changes, particularly budgetary, resulting from regulatory, economic, market or other facts affecting its treasury management activities; and on the performance of the treasury management team.

TMP6 goes on to state that the council should, as a minimum, report annually to full council on their treasury management strategy and plan, before the start of the year; and prepare an annual report on the performance, citing “effects of the decisions taken and the transactions executed in the past year, and on any circumstances of non-compliance with the organisation's treasury management policy statement and TMPs."

Credit Ratings

1: What is a Credit Rating?

- An independent assessment of an organisation
- Gauges likelihood of getting money back on terms it was invested
- Statement of opinion, not statement of fact – no guarantee
- Measure of risk associated with investing with a counterparty

2: The Three Credit Rating Agencies

- Fitch
- Moody's
- Standard & Poors

3: Rating Criteria

Likelihood of getting money back on terms invested

Fitch, Moody's & S&P rate institutions through:

- Short Term Rating – 12 month and less time horizon
- Long Term Rating - Over 12 months

Other Criteria (used to formulate the above)

- Individual (Fitch) / Financial Strength (Moody's) assessing institutions as an independent entity i.e. strong bank Strong profitability & balance sheet integrity (A high E low)

- Support Rating (Fitch) level of external support available i.e. UK Government (1 high 5 low)

Rating Scales

UK Banks	Fitch Rating				Moody's Rating			S & P Rating	
	S. Term	L. Term	Indiv.	Support	S. Term	L. Term	Fin. Stgth	S. Term	L. Term
NatWest / RBS	F1+	AA-	C/D	1	P-1	Aa3	C-	A-1	A+
Santander	F1+	AA-	B	1	P-1	Aa3	C-	A-1+	AA
Lloyds / HBOS	F1+	AA-	C	1	P-1	Aa3	D+	A-1	A+
Barclays	F1+	AA-	B	1	P-1	Aa3	C	A-1+	AA-
HSBC	F1+	AA	B	1	P-1	Aa2	C+	A-1+	AA

Managing Risk (Risk and Return Extract from the Audit Commission)

March 2009

Recommendations – Still Relevant

Local authorities should:

• Set the treasury management framework so that the organisation is explicit about the level of risk it accepts and the balance between security and liquidity and the yield to be achieved. At the highest level, the organisation should decide whether it has:

- appetite and capability to be able to manage risk by placing funds with financial institutions; or
- no appetite and/or insufficient capability to manage the risk of placing funds in the market, and should instead place funds with the UK government's Debt Management Office;

• Ensure that treasury management policies:
- follow the revised CIPFA code of practice;
- are scrutinised in detail by a specialist committee, usually the audit committee, before being accepted by the authority; and
- are monitored regularly;

• Ensure elected members receive regular updates on the full range of risks being run;

• Ensure that the treasury management function is appropriately resourced, commensurate with the risks involved. Staff should have the right skills and have access to information and external advice;

• Train those elected members of authorities who have accountability for the stewardship of public money so that they are able to scrutinise effectively and be accountable for the treasury management function;

• Ensure that the full range of options for managing funds is considered, and note that early repayment of loans, or not borrowing money ahead of need, may reduce risks;

• Use the fullest range of information before deciding where to deposit funds;

• Be clear about the role of external advisers, and recognise that local authorities remain accountable for decisions made.

Appendix 3

Report to:	**Audit , Best Value and Community Services Scrutiny Committee**
Date:	**1 June 2011**
By:	**Director of Corporate Resources**
Title of report:	**Treasury Management – Stewardship Report 2010/11**
Purpose of report:	**To present a review of the County Council's performance on treasury management for the year 2010/11.**

RECOMMENDATION

The Audit and Best Value Scrutiny Committee is recommended to note the treasury management performance in 2010/11.

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1. Introduction

1.1 The County Council has nominated the Audit and Best Value Scrutiny Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

1.2 This Stewardship report for 2010/11 will be considered by the next Cabinet meeting on 5 July 2011.

1.3 The annual stewardship report reviews the Council's treasury management performance and is required by the Code of Practice for Treasury Management.

2. Supporting Information

2.1 Background

The County Council's treasury management activities are regulated by a variety of professional codes and statutes and guidance. The County Council has adopted the CIPFA Code of Practice for Treasury Management in the Public Sector and operates treasury management service in compliance with this Code. These require that the prime objective of the treasury management activity is the effective management of risk, and that its borrowing activities are undertaken in a prudent, affordable and sustainable basis and treasury management practices demonstrate a low risk approach. The Code requires the regular reporting of treasury management activities to:

- Forecast the likely activity for the forthcoming year (in the Annual Treasury Strategy Report); and
- Review actual activity for the proceeding year (this Stewardship report).
- A mid year review (A report was published in November 2010 for the first half year of 2010/11)

This report sets out:

- A summary of the original strategy agreed for 2010/11 and the economic factors affecting this strategy (Appendix A)
- The treasury management activity during the year (Appendix B);
- The Prudential Indicators, which relate to the Treasury function and compliance with limits (Appendix C).

2.2 The economic conditions compared to our original strategy for 2010/11

The original strategy and the economic conditions prevailing in 2010/11 are set out in Appendix A which is attached to this report. 2010/11 continued the challenging environment of the previous years, with the UK economy recovering, albeit weakly. The main implications have been continuing counterparty risk and low investment returns.

2.3 **The treasury activity during the year on short term investments and borrowing;**

The Treasury Management Strategy

The strategy for 2010/11, agreed in January 2010, continued the prudent approach and ensured that all investments were only to the highest quality rated banks and only up to a period of one year. No changes to this Strategy were required but a more prudent approach has been adopted because of the uncertainties in the market. An investment in one bank was temporarily withdrawn and investments in others reduced from a period of up to three months to being on call (overnight only).

Short term lending

The total amount received in short term interest for 2010/11 was £2.29m at an average rate of 0.94%. This was above the average of base rates in the same period (0.5%) but fell short of the aim to secure investment income of at least base rate plus 0.5% on the Council's general cash balances. The return was obtained against a backdrop of ensuring, so far as possible in the current financial climate, the security of principal and the minimisation of risk. This Council has continued to follow an extremely prudent approach with security and liquidity as the main criteria before yield.

Short term borrowing

No borrowing was undertaken on a short-term basis during 2010/11 to cover temporary overdraft situations.

Long term borrowing

Details of our long term borrowing are included in Appendix B of the report. The important points are:

- No new borrowing was undertaking with PWLB during 2010/11. It was agreed to use "internal borrowing" to finance new capital investment
- Although a proactive approach has been taken to repayment and restructuring of debt, no cost effective opportunities have arisen during the year.
- The average interest rate of all debt at 31 March 2011 (£241.2m) was 5.31% unchanged from 31 March 2010 as no new debt was taken in the year. Under the restructuring in February 2010, £23m of new loans were agreed to be taken in February 2012 at a rate of 4.39% to repay £23m of PWLB loans at 4.7% (repaid in February 2010). The average rate of all debt at 31 March 2012 (£264.2m) is estimated to be 5.20% if no new loans are taken and no beneficial rescheduling of debt is available.
- The PWLB increased all of its lending rates on 20th October 2010 (the day of the Government's Comprehensive Spending Review) by 1% on all rates. However, it did not increase the rate of interest used for repaying debt so that not only has the cost of our future borrowing increased, but our opportunity to restructure our debt when market conditions allow has been significantly reduced.

2.4 **Prudential Indicators which relate to the Treasury function and compliance with limits**

The County Council is required by the CIPFA Prudential Code to report the actual prudential indicators after the end of each year. There are eight indicators which relate to treasury management and they are set out in Appendix C. The actual position for the County Council for 2010/11 is that performance against all borrowing and prudential indicators is within the limits set in the Strategy for the year.

3. Conclusion and reason for recommendation

This report updates the Audit and Best Value Scrutiny Committee and fulfils the requirement to submit an annual Stewardship report in the form prescribed in the Treasury Management Code of Practice. This Council has continued to follow an extremely prudent approach with security and liquidity as the main criteria before yield. Exposure to future risk continues to be minimised through proactive and constant review of the treasury management policy.

SEAN NOLAN

Director of Corporate Resources

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	Les Langston	Tel No. 01273 481851

BACKGROUND DOCUMENTS
Cabinet 26 January 2010 Treasury Management Strategy for 2010/11
8 June 2010 Treasury Management Stewardship Report 2009/10
16 November 2010 Treasury Management – Half year review 2010/11
25 January 2011 Treasury Management Strategy for 2011/12
CIPFA Prudential Code and Treasury Management in the Public Services- Code of practice
Local Government Act 2003

Appendix A

A summary of the strategy agreed for 2010/11 and the economic factors affecting this strategy

1. Background information

1.1 Cabinet receive an annual Treasury Management Strategy report, normally in January or February, which sets out the proposed strategy for the year ahead. This strategy includes the limits and criteria for organisations to be used for the investment of cash surpluses and has to be approved by the County Council.

1.2 This Council has always adopted a prudent approach to its investment strategy and in the last few years, there have been regular changes to the list of the approved organisations used for investment of short term surpluses. This list is regularly reviewed to ensure that the Council is able to invest in the best available rates consistent with low risk; the organisations are regularly monitored to ensure that their financial strength and low risk has been maintained.

1.3 When the original strategy for 2010/11 was drawn up earlier in January 2010, the money markets were still volatile with Banks reluctant to lend to each other. In this climate ensuring the security of investments continues to be difficult and extreme caution has to be taken on where surplus funds can be invested.

1.4 At the same time, the Treasury Management Policy Statement was agreed as unchanged for 2010/11.

East Sussex County Council defined its treasury management activities as:

"The management of the organisation's cash flows, its banking, money market and capital market transactions (other than those of the Pension Fund) the effective management of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

The County Council regards the successful identification, monitoring and management of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation.

This authority acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving best value in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management.

2. Borrowing

2.1 In recent years, the County Council had a strategy to borrow to support the Capital Programme and lend out other cash (rather than using internal borrowing). Historically this meant that the interest rate earned on cash balances was higher than the interest rate paid on loans from the Public Works Loans Board (PWLB). In the current financial climate, this interest rate differential has been removed.

2.2 No new PWLB borrowing has taken place since January 2008 and is unlikely in the current climate unless long term PWLB rates reach a very low level (where the long term benefit would exceed the short term costs). Indeed, as well as using the existing cash balances to finance capital spending (rather than new borrowing) it was also considered prudent to repay early some £13m of relatively expensive PWLB loans which was due to mature in the next 5 years. This was completed in February 2009. Further debt repayment or restructuring opportunities were to be monitored.

3. Investment

3.1 When the strategy was agreed in January 2010, it emphasised the importance of taking account of the current and predicted future state of the financial sector. The state of money markets has slightly improved over the last few months. The following factors were taken into account:

- Bank rate was 0.5% (the lowest on record) and these short-term interest rates were expected to remain on hold for a considerable time. The recovery in the economy had commenced but it was expected to remain insipid and there was a danger that early reversal of monetary ease, (rate cuts and Quantative Easing (QE)), could trigger a dip back to negative growth. It was expected that lack of bank activity and weak consumer expenditure in response to future tax rises would also be factors that hold back growth.

- Inflation was set to remain subdued in the next few years (though a sharp blip forecast for the early part of 2010) and the pressure upon the Monetary Policy Committee to hike rates will remain moderate. But some increase was seen to be necessary in 2010 to counter the effects of external cost pressures (as commodity price strength filters through) and to avoid damage that sterling could endure if the UK is seen to defy an international move to commence policy exit strategies.

- Longer term interest rates were expected to be more volatile. There was a prediction of an increase for a number of reasons: 1) net gilt issuance would rise sharply, 2) this would be increased by the extent to which the Bank of England attempted to claw back funds injected to the economy via the QE programme; 3) investors would be looking to place more of their funds in alternative instruments as their risk appetite increases, demand for gilts would weaken as a consequence; 4) a decision to leave QE in place would generate inflation concerns and pressurise long yields higher.

The strategy going forward was to continue with the policy of ensuring minimum risk but would also need to deliver secure investment income of at least bank rate on the Council's cash balances. (The actual target was bank rate plus 0.5%).

4. Strategy agreed for 2010/11

4.1 The strategy ensured that in the economic climate a prudent approach was maintained. This would be achieved through investing with selected banks and funds which met the Council's rating criteria. The emphasis would continue on security (protection of the capital sum invested) and liquidity (keeping money readily available for expenditure when needed) rather than yield. The strategy continued with this prudent approach and the only change agreed was to increase the period of investment to up to a year but only after the Director of Corporate Resources was satisfied that the market conditions were favourable. There was no change to the list of counterparties and the limit of the investment remained at a maximum of £60m.

4.2 It was also recognised that movements within the money markets can happen with no notice and the Director of Corporate Resources would have to amend this strategy in order to safeguard Council funds. As in the past any such actions would be reported to the next Cabinet meeting.

4.3 It was not expected that any new external borrowing would be undertaken in 2010/11 however the limits set in the Authorised Limit for Borrowing would allow such borrowing. External borrowing would only take place if the rates available were so low that the long term benefits will significantly exceed the short term cost.

4.4 Opportunities for cost effective repayment of existing debt and restructuring opportunities were to be constantly monitored and would be taken if and when they emerge.

4.5 Our policy gave some flexibility to borrow up to £23m in advance of future need. However, given the current interest climate, no external borrowing and certainly none in advance was planned.

4.6 The funds of the Fire Authority would continue to be invested in line with their own specific policy.

4.7 The County Council funds would be invested as follows.

<u>Up to a maximum of £60m deposited up to a period of up to one year</u> with any of the following: -

Bank / Fund
Barclays
Lloyds HBOS
Nat West/RBS
Santander UK
HSBC
Nationwide
Individual Treasury Type Money Market Funds (AAA rated)
Individual Cash Type Money Market Funds (AAA rated)

Only banks which are eligible for the Government's Credit Guarantee Scheme AND meet the following minimum rating criteria for at least two of the designated agencies were to be used.

Ratings Agency	Long Term	Short Term
Fitch	AA-	F1+
Moody	AA3	P-1
Standards and Poors	AA-	A-1+

The policy retained the ability to revert to some, or even extensive use of the Government's Debt Management Account Deposit Facility (DMADF) if market risk conditions tighten.

4.8 Additional requirements under the Code of Practice required the Council to supplement credit rating information. The above criteria relied primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use. However, additional operational market information had been and would continue to be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example Credit Default Swaps, equity prices etc.) would be assessed when comparing the relative security of differing investment counterparties.

4.9 All of the investments were to be classified as Specified Investments. These investments are sterling investments of not more than one-year maturity with institutions deemed to be high credit quality or with the UK Government (Debt Management Account Deposit Facility). These are considered low risk assets where the possible loss of principal or investment income is small. The County Council does not have any Non Specified Investments which more than one-year maturity or with institutions which have a lesser credit quality.

5. The economy in 2010/11 – Commentary from Sector (Treasury Management Advisors) in May 2011.

5.1 2010/11 proved to be another watershed year for financial markets. Rather than a focus on individual institutions, market fears moved to sovereign debt issues, in particular those in the peripheral Euro zone economies. Local authorities were also presented with changed circumstances following the unexpected change of policy on Public Works Loan Board (PWLB) lending arrangements in October 2010. This resulted in an increase in new borrowing rates of 0.75 – 0.85%, but no increase in early redemption rates.

5.2 UK growth proved mixed over the year. The first half saw the economy outperform expectations, but the economy slipped into negative territory in the final quarter of 2010 due to inclement weather conditions. The year finished with prospects for the UK economy being decidedly downbeat over the short to medium term while the Japanese disasters in March, and the Arab spring, especially the crisis in Libya, caused an increase in world oil prices, which all combined to dampen international economic growth prospects.

5.3 The change in the UK political background was a major factor behind weaker domestic growth expectations. The new coalition Government struck an aggressive fiscal policy stance, evidenced through heavy spending cuts announced in the October Comprehensive Spending Review, and the lack of any "giveaway" in the March 2011 Budget. Although the main aim was to reduce the national debt burden to a sustainable level, the measures are expected to also act as a drag on growth.

5.4 Gilt yields fell for much of the first half of the year as financial markets drew considerable reassurance from the Government's debt reduction plans, especially in the light of Euro zone sovereign debt concerns. Expectations of further quantitative easing also helped to push yields down to historic lows. However, this positive performance was mostly reversed in the closing months of 2010 as sentiment changed due to sharply rising inflation pressures. These were also expected to cause the Monetary Policy Committee (MPC) to start raising Bank Rate earlier than previously expected.

5.5 The developing Euro zone peripheral sovereign debt crisis caused considerable concerns in financial markets. First Greece (May), then Ireland (December), were forced to accept assistance from a combined EU / IMF rescue package. These worries caused international investors to seek safe havens in investing in non-Euro zone government bonds.

5.6 Deposit rates picked up in the second half of the year as rising inflationary concerns, and strong first half growth, fed through to prospects of an earlier start to increases in Bank Rate. However, in March 2011, slowing growth and weak growth prospects saw consensus expectations of the first UK rate rise move back from May to August 2011 despite high inflation. However, the disparity of expectations on domestic economic growth and inflation encouraged a wide range of views on the timing of the start of increases in Bank Rate in a band from May 2011 through to early 2013. This sharp disparity was also seen in MPC voting which, by year end, had three members voting for a rise while others preferred to continue maintaining rates at ultra low levels.

5.7 Risk premiums were also a constant factor in raising money market deposit rates beyond 3 months. Although market sentiment has improved, continued Euro zone concerns, and the significant funding issues still faced by many financial institutions, mean that investors remain cautious of longer-term commitment. The European Commission did try to address market concerns through a stress test of major financial institutions in July 2010. Although only a small minority of banks "failed" the test, investors were highly sceptical as to the robustness of the tests, as they also are over further tests now taking place with results due in mid-2011.

Appendix B

The treasury management activity during the year

1. Short term lending interest rates

1.1 Base interest rate remained at 0.5% throughout 2010/11. The rate is the lowest ever rate and the rate has remained unchanged for the longest period on record.

1.2 There have been continued uncertainties in the markets during the year to date as set out in Section 5 of Appendix A.

1.3 Credit ratings have been used to monitor the banks used under our strategy as well as additional market information such as Credit Default Swaps, equity prices, sovereign ratings as well information through the media.

1.4 The strategy for 2010/11, agreed in January 2010, continued the prudent approach and ensured that all investments were only to the highest quality rated banks and only up to a period of one year. No changes to this Strategy have been required but a more prudent approach has been adopted because of the uncertainties in the market. An investment in one bank was temporarily withdrawn and investments in others reduced from a period of up to three months to being on call (overnight only).

1.5 The total amount received in short term interest for 2010/11 was £2.29m at an average rate of 0.94%. This was above the average of base rates in the same period (0.5%) but fell short of the aim to secure investment income of at least base rate plus 0.5% on the Council's general cash balances. This was against a backdrop ensuring, so far as possible in the financial climate, the security of principal and the minimisation of risk. This Council has continued to follow an extremely prudent approach with security and liquidity as the main criteria before yield.

2. Long term borrowing

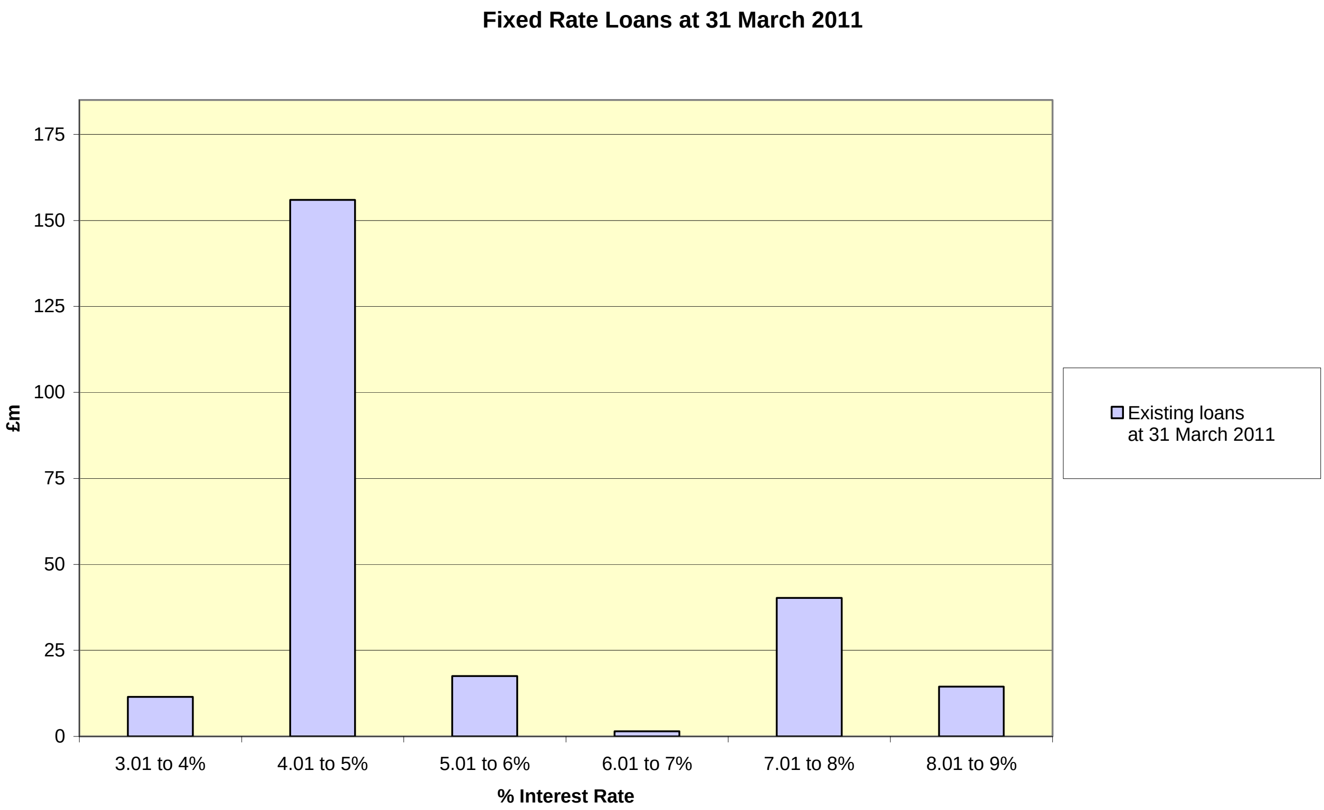
2.1 The County Council has had a strategy to borrow to support the Capital Programme and lend out other cash (rather than using internal borrowing). Historically this meant that the interest rate earned on cash balances was higher than the interest rate paid on loans from the Public Works Loans Board (PWLB). In the current financial climate, this interest rate differential has been removed. No new PWLB borrowing has taken place since January 2008 and is unlikely in the current climate unless long term PWLB rates reach a very low level (where the long term benefit would exceed the short term costs).

2.2 As well as using the existing cash balances to finance capital spending (rather than new borrowing), a restructure of our debt was undertaken in February 2010 where £23m of PWLB loans at a rate of 4.7% was repaid and will be replaced in February 2012 with market loans of £23m at rate of 4.39%. The repayments of PWLB loans and the replacement with market loans in two years time will result in a total savings of £1,149,153 over the first seven years after taking into account a premium payment made to the PWLB for compensation for an early repayment of loans. This was reported in the Stewardship report to Cabinet in June 2010.

2.3 The average interest rate of all debt at 31 March 2011 (£241.2m) was 5.31% and was unchanged from 31 March 2010 as no new borrowing was undertaken in 2010/11. Under the restructuring in February 2010, £23m of new loans were agreed to be taken in February 2012 at a rate of 4.39% to repay £23m of PWLB loans at 4.7% (repaid in February 2010). The average rate of all debt at 31 March 2012 (£264.2m) is estimated to be 5.20% as long as no new loans are taken and no beneficial rescheduling of debt is available.

2.4 The PWLB increased all of its lending rates on 20th October 2010 (the day of the Government's Comprehensive Spending Review) by 1% on all rates. However, it did not increase the rate of interest used for repaying debt so that not only the cost of our future borrowing has increased but our opportunity to restructure our debt when market conditions allow has been significantly reduced.

The range of interest rates payable in all of the loans is illustrated in the graph below:



3. Short term borrowing

3.1 No borrowing was undertaken on a short-term basis during 2010/11 to date to cover temporary overdraft situations.

4 Treasury Management Advisers

4.1 The Strategy for 2010/11 explained that the County Council uses Butlers as its treasury management consultant on a range of services which include:

- Technical support on treasury matters, capital finance issues and advice on reporting;
- Economic and interest rate analysis;
- Debt services which includes advice on the timing of borrowing;
- Debt rescheduling advice surrounding the existing portfolio;
- Generic investment advice on interest rates, timing and investment instruments;
- Credit ratings from the three main credit rating agencies and other market information;
- Assistance with training on treasury matters

Whilst the advisers provide support to the internal treasury function, under current market rules and the CIPFA Code of Practice the final decision on treasury matters remained with the Council. This service remains subject to regular review.

4.2 Butlers merged with Sector from the end of October 2010. The County Council has the same terms and conditions as before the transfer. Sector is the largest provider of Treasury Management advice services to local authorities in the UK. Sector has stated that this merger will strengthen their ability to provide the market-leading treasury management service to their clients and better those offered by competitors.

4.3 The advice has been and will continue to be monitored regularly to ensure a continued advisory service at similar or better to the excellent level provided by Butlers.

Appendix C

Prudential Indicators which relate to the Treasury function and compliance with limits

1.1 The County Council is required by the Prudential Code to report the actual prudential indicators after the end of each year. There are eight indicators which relate to treasury management and they are set on an annual basis and monitored, they comprise:-:

- Operational and authorised borrowing limits which includes short term borrowing (paragraph 1.2 below)
- Interest rate exposure (paragraph 1.3 below)
- Interest rate on long term borrowing (paragraph 1.4 below)
- Maturity structure of debt (paragraph 1.5 below)
- Maturity structure of investments (paragraph 1.6 below)
- Compliance with the Treasury Management Code of Practice (paragraph 1.7 below)
- Interest on investments (paragraph 1.8 below)
- Capital Financing Requirement and Minimum Revenue Provision (paragraph 1.9 below)

None of the limits has been exceeded in 2010/11.

1.2 **Operational and authorised borrowing limits.**

The tables below sets out the estimate and projected capital financing requirement and long-term borrowing in 2010/11

	CAPITAL FINANCING REQUIREMENT	**2010/11**	**2010/11**
		Estimate £m	**Likely Actual £m**
	Capital financing requirement at 1 April 2010	295	333
ADD	Borrowing to support capital programme	27	27
LESS	Provision for repayments of debt	-12	-13
		-------	-------
	Capital financing requirement at 31 March 2011	**310**	**347**
ADD	Net borrowing for next year	23	

	Operational boundary	**333**	
ADD	Short term borrowing	20	Nil

	Authorised limit	**353**	

	ACTUAL BORROWING	**2010/11**
		Actual £m
	Long term borrowing at 1 April 2010	241.2
ADD	Borrowing to support capital programme	-----
LESS	Repayment of PWLB debt	-----
	Long term borrowing at 31 March 2011	**241.2**

The Operational boundary for borrowing was based on the same estimates as the authorised limit. It reflected directly the authorised borrowing limit estimate without the additional amount for short term borrowing included to allow, for example, for unusual cash movements. The Operational boundary represents a key management tool for in year monitoring and long term borrowing control.

The Authorised limit was consistent with the County Council's current commitments, existing plans and the proposals for capital expenditure and financing, and with its approved treasury management policy statement and practices. It was based on the estimate of most likely, prudent but not worst case scenario, with in addition sufficient headroom (short term borrowing) over and above this to allow for day to day operational management, for example unusual cash movements or late receipt of income. Risk analysis and risk management strategies were taken into account as were plans for capital expenditure, estimates of the capital financing requirement and estimates of cash flow requirements for all purposes.

The Authorised limit is the "Affordable Borrowing Limit" required by S3 of the Local Government Act 2003 and must not be breached. The Long term borrowing at 31st March 2011 of £241m is under the Operational boundary and Authorised limit set for 2010/11. The Operational boundary and Authorised limit have not been exceeded during the year.

1.3 **Interest rate exposure**

The County Council continued the practice of seeking to secure competitive fixed interest rate exposure for 2010/11. To provide flexibility however it set limits on our variable rate exposure in case that became a more effective approach. There are figures for both borrowing and lending and a combined borrowing and lending table.

Borrowing	2010/11 Estimate	2010/11 Actual
Fixed Rate Exposure		
Upper Limit	100%	100%
Lower Limit *	55%	
Variable Rate Exposure		
Upper Limit	45%	0%
Lower Limit *	0%	

(* assumes all new borrowing is variable)

Lending		
Fixed Rate Exposure		
Upper Limit	100%	86%
Lower Limit	0%	
Variable Rate Exposure		
Upper Limit	100%	14%
Lower Limit	0%	

Borrowing and Lending combined		
Fixed Rate Exposure		
Upper Limit	100%	93%
Lower Limit	28%	
Variable Rate Exposure		
Upper Limit	100%	7%
Lower Limit	0%	

In 2010/11, all lending has been at fixed rates with the exception of the investments with Money Market Funds.

1.4 **Interest rate on long term borrowing**

The rate of interest taken on new long term borrowing will be monitored as the following targets have been set.

- Rate taken on borrowing is within 0.25% of lowest point for set loan period (i.e. 45-50 years) during the year

- Rate taken is within lowest eighth of rates available for set loan period (i.e. 45-50 years) during the year

No new borrowing has been taken in 2010/11.

1.5 Maturity structure of debt

The Council has set upper and lower limits for the maturity structure of its borrowings as follows.

	Lower limit	Upper limit
Under 12 months	0%	25%
12 months and within 24 months	0%	40%
24 months and within 5 years	0%	60%
5 years and within 10 years	0%	80%
10 years and within 20 years	0%	80%
20 years and within 30 years	0%	80%
30 years and within 40 years	0%	80%
40 years and above	0%	80%

The County Council has not exceeded the limits set in 2010/11.

	Actual at 31.3.2011
Under 12 months	0%
12 months and within 24 months	0%
24 months and within 5 years	3%
5 years and within 10 years	9%
10 years and within 20 years	19%
20 years and within 30 years	14%
30 years and within 40 years	20%
40 years and above	35%

In addition, two targets have monitored the maturity structure of our debt. Not more than £20m of debt should mature in any financial year and not more than 15% to mature in any two consecutive financial years. These targets are both in line at 31st March 2011.

New borrowing has been undertaken giving due consideration to the debt maturity profile, ensuring that an acceptable amount of debt is due to mature in any one financial year. This helps to minimise the authority's exposure to the risk of having to replace a large amount of debt in any one year or period when interest rates may be unfavourable. The bar chart in the attached Annex shows the maturity profile.

1.6 Maturity structure of investments

From 1 April 2004, the Investment Guidance issued by the Officer of Deputy Prime Minister, allowed local authorities the freedom to invest for more than for one year. All investments over one year were to be classified as Non-Specified Investments. The County Council had taken advantage of this freedom in previous years. No Non-Specified Investments are held within our overall portfolio of investments and in line with our prudent approach in our strategy, no new long term investments (over 364 days) have been taken in 2010/11.

1.7 Compliance with the Treasury Management Code of Practice

East Sussex County Council has adopted the CIPFA *Code of Practice for Treasury Management in the Public Services.*

1.8 **Interest on investments**

The table below sets out the average monthly rate received on our investments and compares it to the Bank of England Base rate to reflect both the interest rates available in the market and limitation in the use of counterparties.

Month	Amount £000	Monthly rate	Margin over Base rate	Margin against Base plus 0.5%
April	192.9	0.98%	0.48%	-0.02%
May	193.7	0.95%	0.45%	-0.05%
June	184.5	0.89%	0.39%	-0.11%
July	189.4	0.90%	0.40%	-0.10%
August	185.5	0.91%	0.41%	-0.09%
September	188.0	0.88%	0.38%	-0.12%
October	199.7	0.94%	0.44%	-0.06%
November	191.3	0.95%	0.45%	-0.05%
December	197.2	0.96%	0.46%	-0.04%
January	197.7	0.96%	0.46%	-0.04%
February	175.0	0.97%	0.47%	-0.03%
March	192.9	0.98%	0.48%	-0.02%
Total for 2010/11	**2.287.8**	**0.94%**	**0.44%**	**-0.06%**

The total amount received in short term interest for the year was £2.29m at an average rate of 0.94%. This was above the average of base rates in the same period (0.5%) but below the aim to secure investment income of at least base rate plus 0.5% on the Council's general cash balances whilst ensuring, so far as possible in the financial climate, the security of principal and the minimisation of risk. This Council has continued to follow an extremely prudent approach with security and liquidity as the main criteria before yield.

1.9 Capital Financing Requirement and Minimum Revenue Provision (MRP) Statement

<u>The Council's Borrowing Need (the Capital Financing Requirement)</u>

1.10 The prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of Council's underlying borrowing need.

1.11 The Council is asked to approve the CFR projections below:

1.12

£m	2010/11 Estimated	2010/11 Likely Actual	2011/12 Estimated	2012/13 Estimated
Total CFR	**333**	**333**	**347**	**358**
Movement in CFR	**14**	**14**	**11**	**7**

Movement in CFR represented by				
Net financing need for the year (above)	27	27	25	21
MRP/Voluntary Revenue Provision (VRP) and other financing movements	-13	-13	-14	-14
Movement in CFR	**14**	**14**	**11**	**7**

The Council is required to pay off an element of the accumulated General Fund capital spend each year through a revenue charge (the Minimum Revenue Provision – MRP).

Minimum Revenue Provision (MRP) Statement

1.13 The statutory requirement for local authorities to charge the Revenue Account each year with a specific sum for debt repayment was replaced in February 2008 with more flexible statutory guidance which came into effect from 2008/09. A variety of options is provided to councils to replace the existing Regulations, so long as there is a prudent provision.

1.14 The new statutory duty is that a local authority shall determine for the financial year an amount of minimum revenue provision (MRP) that it considers to be prudent. This replaces the previous prescriptive requirement that the minimum sum should be 4% of the Council's Capital Financing Requirement (CFR).

1.15 To support the statutory duty the Government also issued a guidance which requires that a Statement on the Council's policy for its annual MRP should be submitted to the full Council for approval before the start the financial year to which the provision will relate. The Council are therefore legally obliged to have regard to this MRP guidance in the same way as applies to other statutory guidance such as the CIPFA Prudential Code, the CIPFA Treasury Management Code and the CLG guidance on Investments.

1.16 The MRP guidance offers four options under which MRP might be made, with an overriding recommendation that the County Council should make prudent provision to redeem its debt liability over a period which is commensurate with that over which the capital expenditure is estimated to provide benefits (i.e. estimated useful life of the asset being financed).

1.17 The guidance also requires an annual review of MRP policy being undertaken and it is appropriate that this is done as part of this Annual Treasury Management Strategy.

1.18 The move to International Financial Reporting Standards (IFRS) from 2010/11 involves Private Finance Initiative (PFI) contracts and some leases (being reclassified as finance leases instead of operating leases) coming onto the County Council Balance Sheets as long term liabilities. This new accounting treatment impacts on the Capital Financing Requirement with the result that an annual MRP provision is required (from 2009/10 in the case of PFI's).

1.19 The policy recommended for adoption from 1 April 2010 retains the key elements of the policy previously approved but now incorporates the IFRS changes (re PFI and finance leases) and the consequential updated Government Guidance.

1.20 For capital expenditure incurred before 1 April 2008 or which in the future will Supported Capital Expenditure, the MRP policy will be:

- Based on based on the non-housing CFR, i.e., The Council currently set aside a Minimum Repayment Provision based on basic MRP of 4% each year to pay for past capital expenditure and to reduce its CFR.

1.21 From 1 April 2008 for all unsupported borrowing the MRP policy will be:

- Asset Life Method – MRP will be based on the estimated life of the assets, in accordance with the regulations.

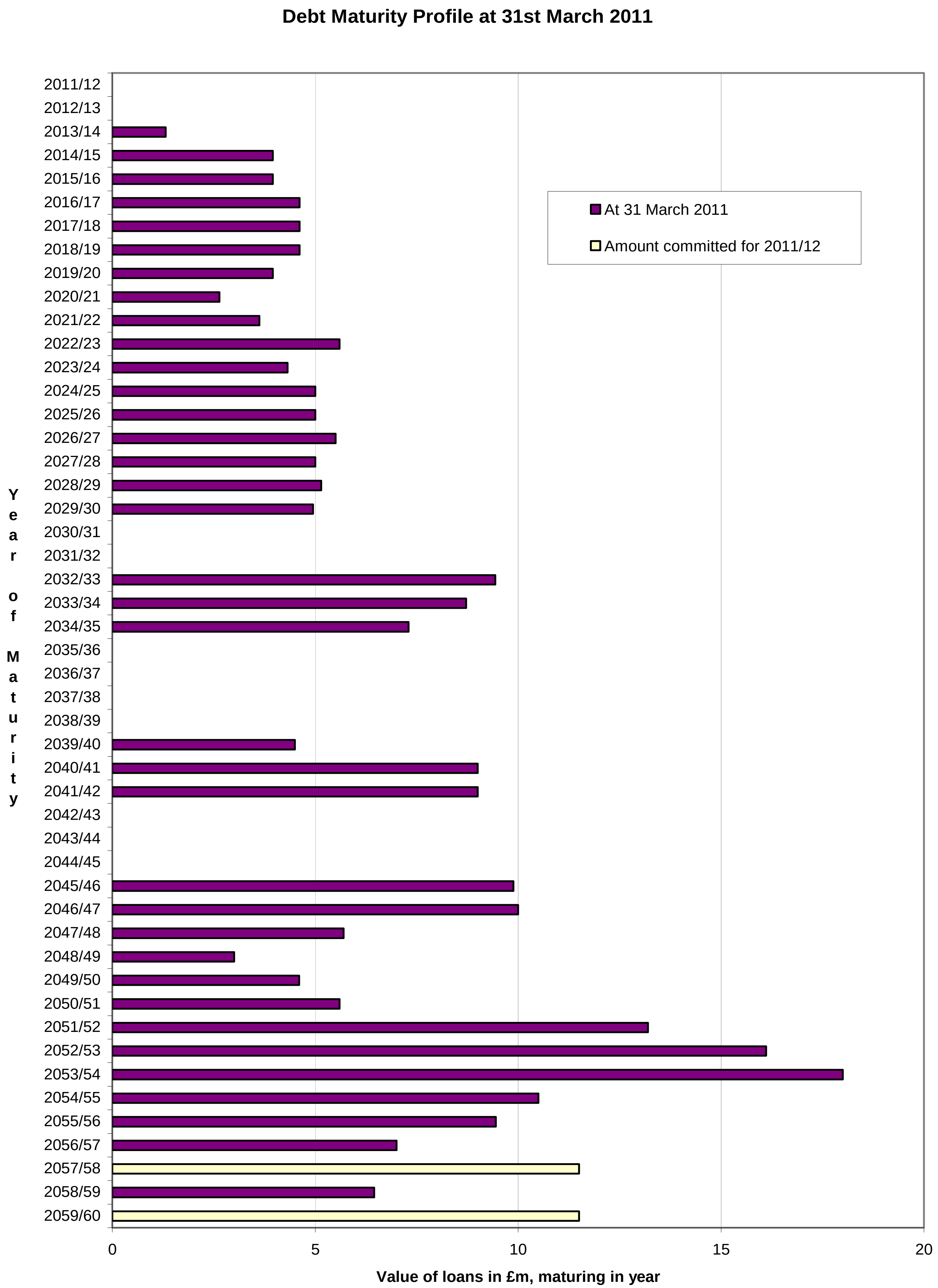
- Asset Life Method (annuity method) The Council will also be adopting the annuity method, - MRP calculated according to the flow of benefits from the asset, and where the principal repayments increase over the life of the asset. The policy is being adopted as a result of any PFI s assets coming on the balance sheet and any related MRP will be equivalent to the "capital repayment element" of the annual service charge payable to the PFI Operator and for finance leases, MRP will also be equivalent to the "capital repayment (principal) element" of the annual rental payable under the lease agreement.

Under both methods, the Council has the option to charge more than the statutory MRP each year through a Voluntary Revenue Provision (VRP).

1.22 In view of the variety of different types of capital expenditure incurred by the County Council, which is not in all cases capable of being related to an individual asset, asset lives will be assessed on a basis which most reasonably reflects the anticipated period of benefit that arises from the expenditure. Also whatever type of expenditure is involved, it will be grouped together in a manner which reflects the nature of the main component of expenditure.

1.23 This approach also allows the Council to defer the introduction of an MRP charge for new capital projects/land purchases until the year after the new asset becomes operational rather than in the year borrowing is required to finance the capital spending. This approach is beneficial for projects that take more than one year to complete and is therefore included as part of the MRP policy. Half-yearly review of the Council's MRP Policy will be undertaken and reported to Members as part of the Half-yearly Treasury Management Strategy review.

Annex


Debt Maturity Profile at 31st March 2011
At 31 March 2011
Amount committed for 2011/12
Year of Maturity
2011/12
2012/13
2013/14
2014/15
2015/16
2016/17
2017/18
2018/19
2019/20
2020/21
2021/22
2022/23
2023/24
2024/25
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2051/52
2052/53
2053/54
2054/55
2055/56
2056/57
2057/58
2058/59
2059/60
0
5
10
15
20
Value of loans in £m, maturing in year