Report to:	**Audit, Best Value and Community Services Scrutiny Committee**
Date:	**1 June 2012**
By:	**Interim Director of Corporate Resources**
Title of report:	**Treasury Management – Stewardship Report 2011/12**
Purpose of report:	**To present a review of the County Council's performance on treasury management for the year 2011/12.**

RECOMMENDATION: The Audit, Best Value and Community Services Scrutiny Committee is recommended to note the treasury management performance in 2011/12.

1. Introduction

1.1 The County Council has nominated the Audit, Best Value and Community Services Scrutiny Committee to be responsible for ensuring effective scrutiny of the Treasury Management Strategy and policies.

1.2 This Stewardship report for 2011/12 will be considered by the next Cabinet meeting on 12 June 2012.

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 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 preceding year (this Stewardship report).
- A mid year review

2.2 This report sets out:

- A summary of the original strategy agreed for 2011/12 and the economic factors affecting this strategy and the amendment to the strategy agreed in November 2011 to take account of the change in market conditions. (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).

3. The economic conditions compared to our original Strategy for 2011/12

3.1 The original strategy and the economic conditions prevailing in 2011/12 are set out in Appendix A which is attached to this report. 2011/12 continued the challenging environment of the previous years, with concerns over the economies of European countries and their impact on the UK economy. The main implications have been continuing counterparty risk and low investment returns.

4. The Treasury activity during the year on short term investments and borrowing

<u>The Treasury Management Strategy</u>

4.1 The strategy for 2011/12, agreed in January 2011, 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. A more

prudent approach was adopted because of the uncertainties in the market and investments were reduced from a period of up to three months to being on call (overnight only). By the middle of September, all investments were able to be called without notice. The strategy was altered in November to reflect changes in market conditions and the Government's part ownership of certain Banks. The emphasis was to be able to react quickly if market conditions worsen.

Short term lending

4.2 The total amount received in short term interest for 2011/12 was £2.6m at an average rate of 0.91%. 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

4.3 No borrowing was undertaken on a short-term basis during 2011/12 to cover temporary overdraft situations.

Long term borrowing

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

- Under the restructuring in February 2010, £23m of new loans was taken in February 2012 at a rate of 4.39% to repay £23m of PWLB loans at 4.7% (repaid in February 2010).
- No other new borrowing was undertaking with PWLB during 2011/12. It was agreed to use "internal borrowing" to finance new capital investment
- The average interest rate of all debt at 31 March 2012 (£264.2m) was 5.20%.
- Although a proactive approach has been taken to repayment and restructuring of debt, no cost effective opportunities arose during the year.

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

5.1 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.

6. Conclusion and reason for recommendation

6.1 This report updates the Audit, Best Value and Community Services 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. The emphasis was and continues to be able to react quickly if market conditions worsen.

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BACKGROUND DOCUMENTS

Cabinet
25 January 2011 Treasury Management Strategy for 2011/12
5 July 2011 Treasury Management Stewardship Report 2010/11
15 November 2011 Treasury Management – Half year review 2011/12
26 January 2012 Treasury Management Strategy for 2012/13

Audit, Best Value and Community Services Scrutiny
1 September 2011 Stewardship Report 2010/11
9 November 2011 Update on Treasury Management

CIPFA Prudential Code and Treasury Management in the Public Services- Code of practice
Local Government Act 2003 Local Government Investments guidance

Appendix A

A summary of the strategy agreed for 2011/12 and the economic factors affecting this strategy and amendments to this strategy in the year

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 2011/12 was drawn up in January 2011, 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 2011/12.

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. Long term 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).

2.3 In February 2010, a restructure of our debt was undertaken where £23m of PWLB loans at a rate of 4.7% was repaid and replaced in February 2012 with market loans of £23m at a rate of 4.39%. The repayments of PWLB loans and the replacement with market loans will result in a total savings of £1.1m over seven years. This was reported in the Stewardship report to Cabinet in June 2010.

2.4 Further debt repayment or restructuring opportunities were to be monitored.

3. Investment

3.1 When the strategy was agreed in January of 2011, the advice given to us by our advisors, Sector, was that short term rates were expected to remain on hold for a considerable time. The recovery in the economy had commenced, however recent growth figures were unlikely to be sustained. The danger of a double-dip recession was fading but the crisis in the euro-zone, the prospects of tight economic policies at home and tenuous consumer confidence meant the threat had still not evaporated completely.

3.2 The Government's determination to cut the size of the public sector deficit considerably more quickly than its predecessor would be a drag upon activity in the medium term. The void left by significant cuts in public spending will have to be filled by a number of alternatives – corporate investment, rising exports and consumers' expenditure. In terms of sheer magnitude, the latter was the most important and a strong recovery in this area was by no means certain. Without a rebound in personal spending, any recovery in the economy was set to be weak and protracted.

3.3 The Bank of England admitted that inflation will remain above target until 2012. Inflation performance remained a key risk to the future course of interest rates. Nevertheless, the perceived need to counter the fiscal squeeze via accommodative monetary policy suggested that barring deterioration from the current situation, the Monetary Policy Committee (MPC) would be prepared to hold rates at very low levels until the latter stages of 2011.

3.4 The outlook for long-term interest rates was favourable in the near term but was set to deteriorate in the latter part of 2011. Yields would be suppressed by continued investor demand for safe haven instruments following the uncertainties and unfolding tensions within the entire Eurozone. In addition to this, the market had been underpinned by evidence of decelerating activity in major economies and the coalition government's apparent determination to deal with the parlous state of public sector finances.

3.5 However, it was advised that while the UK's fiscal burden would almost certainly ease, it would be a lengthy process and deficits over the next two to three financial years would still require a very heavy programme of gilt issuance. Eventually, the absence of the Bank of England as the largest buyer of gilts would shift the balance between supply and demand in the gilt-edged market. Other investors would almost certainly require some incentive to continue buying government paper. This incentive would take the form of higher yields.

4. Original Strategy agreed for 2011/12

4.1 The strategy ensured that in the current economic climate a prudent approach was maintained. This would be achieved through investing with selected banks and funds which meet 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 no change was proposed to change the period of investment from up to a year. There was no change to the list of counterparties or the limit of the investment which remained at a maximum of £60m.

4.2 It was 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 New external borrowing was not anticipated for 2011/12 however the limits set out in the Authorised Limit for Borrowing would allow for such borrowing. External borrowing would only take place if the rates available were so low that the long term benefits would 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 £18m 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:-

Up to a maximum of £60m deposited up to a period of up to one year 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 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 The strategy going forward would 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%).

4.9 Additional requirements under the Code of Practice required the Council to supplement credit rating information. Whilst the above criteria relied primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, 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 Sovereign ratings, Credit Default Swaps, equity prices, the Sector security and liquidity model and the CIPFA National treasury risk model as well as media updates etc.) would be assessed when comparing the relative security of differing investment counterparties.

4.10 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 possibility of loss of principal or investment income is small. The County Council does not have any Non Specified Investments which are ones of more than one-year maturity or with institutions which have a lesser credit quality.

5. Amendment and Revised Strategy for 2011/12

5.1 Our Treasury Management Policy 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.

5.2 Although our Strategy allows for investments up to one year, the continuing uncertainties in the markets dictated that we continued with a mainly overnight (on call) policy with some small amounts of three month investments. In the summer we switched to a complete on call policy and by mid September all of our investments could be returned within a working day.

5.3 On 7th October, the ratings agency Moody's reduced the credit ratings of twelve UK financial institutions including NatWest/RBS, Lloyds / HBOS and Santander UK. On 13th October, the ratings agency Fitch reduced the credit ratings of two UK financial institutions NatWest/RBS and Lloyds / HBOS. These rating agency reviews were part of a previously announced (May 2011) reassessment of the likely level of systemic (Government) support these institutions would get IF they were to get into financial difficulty in the future. The resultant downgrading was not necessarily to be construed that these institutions were experiencing difficulty that would result in a default.

5.4 The consequence of the bank downgrades meant we were then operating outside our normal rating criteria with two banks i.e. ~ NatWest/RBS and Lloyds/HBOS ~ which fell below our minimum rating agency thresholds but within overall policy because the Director of Corporate Resources had discretion.

5.5 The position at that time was that we have continued to invest in both Nat West/RBS and Lloyds/HBOS because

- The high level of Government Ownership of NatWest./RBS is (83%) and Lloyds HBOS (40.2%)
- UK Sovereign rating remained at AAA.
- We had overnight policy and monies could be withdrawn without notice.
- Nat West/RBS is the County Council's banker.

5.6 The changes above required the Strategy for 2011/12 to be amended to continue with the prime objective of the effective management of risk and following our prudent policy. The changes were agreed at the Cabinet meeting on 15 November 2011.

5.7 The policy for the investment of County Council funds was changed as follows:-

(A) UK Investment Without Government Equity Holding

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

The current policy stance was overnight but the policy allows changes to reflect market conditions if and when they improved.

Bank / Fund / Local Authority
Barclays
Santander UK
HSBC
Nationwide
Individual Treasury Type Money Market Funds (AAA rated) which invest in Government Securities only
Individual Cash Type Money Market Funds (AAA rated)
Another Local Authority (Equivalent to the low risk of investing with the Government but not formally rated)

Only banks which met 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+

(B) UK Investment With Government Equity Holding of minimum of 30%

We took 30% as a minimum level of significant associated company influence. In practice it serves as a trigger to formally review our position.

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Up to a maximum of £60m deposited up to a period of up to three months with the following: -

The policy stance was overnight but the policy allowed changes to reflect market conditions if and when they improved.

Bank
Lloyds/HBOS Nat West/RBS

Only banks which met the following minimum rating criteria for at least two of the designated agencies were to be used. The banks would not be used if the UK Sovereign rating falls below AAA.

Ratings Agency	Long Term	Short Term
Fitch	A	F1
Moody	A2	P-1
Standards and Poors	A	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.

5.8 In addition to the Credit Ratings Agencies, various methods have and will be used to monitor the Banks and Funds. Other very safe alternative investments would be explored if they become available.

Although Santander UK and Barclays were listed as Banks which could be used for investments, their ratings fell for two out of the three Credit Rating Agencies below the criteria set. The investment was withdrawn from Santander UK on 4th November and Barclays on 16th December.

5.9 The changes in our policy were summarised as follows:-

- The policy split the investments into two groups,
  (A) UK Investment Without Government Equity Holding and
  (B) UK Investment With Government Equity Holding of a minimum of 30%

UK Investment Without Government Equity Holding

- The reference to the Government's Credit Guarantee Scheme was deleted as it was not relevant.
- Investments could be made to other Local Authorities. (Equivalent to the low risk of investing with the Government but not formally rated)
- The policy allowed investments up to one year but would only be used if market conditions improve. The policy was overnight only.

UK Investment With Government Equity Holding of a minimum of 30%

- Lloyds/HBOS and Nat West/RBS included within UK Investment With Government Equity Holding of over 30%
- The investment allowed up to three months (but the policy at the time and has continued to be overnight) and allowed changes to reflect market conditions if and when they improved.
- New lower ratings criteria but the banks would not be used if the UK Sovereign rating fell below AAA.

It was continued to be 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.

6. The economy in 2011/12 – Commentary from Sector (Treasury Management Advisors) in May 2012.

6.1 The financial year 2011/12 continued the challenging investment environment of previous years, namely low investment returns and continuing heightened levels of counterparty risk. The original expectation for 2011/12 was that Bank Rate would start gently rising from the last quarter of 2011. However, economic growth in the UK was disappointing during the year due to the UK austerity programme, weak consumer confidence and spending, a lack of rebalancing of the UK economy to exporting and weak growth in our biggest export market - the European Union (EU). The UK coalition Government maintained its tight fiscal policy stance against a background of warnings from two credit rating agencies that the UK could lose its AAA credit rating. Key to retaining this rating will be a return to strong economic growth in order to reduce the national debt burden to a sustainable level, within the austerity plan timeframe.

6.2 The USA and France lost their AAA credit ratings from one rating agency during the year. Weak UK growth resulted in the Monetary Policy Committee increasing quantitative easing by £75bn in October and another £50bn in February. Bank Rate therefore ended the year unchanged at 0.5% while inflation peaked in September at 5.2% but then fell to 3.4% in February, with further falls expected to below 2% over the next two years. The EU sovereign debt crisis grew in intensity during the year until February when a second bailout package was eventually agreed for Greece.

6.3 Gilt yields fell for much of the year, until February, as concerns continued building over the EU debt crisis. This resulted in safe haven flows into UK gilts which, together with the two UK packages of quantitative easing during the year, combined to depress PWLB rates to historically low levels.

6.4 Investment rates were affected by risk premiums which were a constant factor in raising money market deposit rates for periods longer than one month. Widespread and multiple downgrades of the ratings of many banks and sovereigns, continued Eurozone concerns, and the significant funding issues still faced by many financial institutions, meant that investors remained cautious of longer-term commitment.

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 2011/12. The rate is the lowest ever rate and the rate has remained unchanged for the longest period on record. The last change was over three years ago in March 2009.

1.2 There have been continued uncertainties in the markets during the year to date as set out in Section 6 of Appendix A.

1.3 Additional market information including Sovereign ratings, Credit Default Swaps, equity prices, the Sector security and liquidity model and the CIPFA National treasury risk model as well as media updates etc have been used to assess the relative security of differing investment counterparties.

1.4 The strategy for 2011/12, agreed in January 2011, 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. A more prudent approach had to be adopted because of the uncertainties in the market. Investments in some banks were reduced from a period of up to three months to being on call (overnight only) and by the middle of September, all investments were able to be called with no notice. The overnight policy continued during the remaining months of 2011/12.

1.5 The total amount received in short term interest for 2011/12 was £2.6m at an average rate of 0.91%. 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

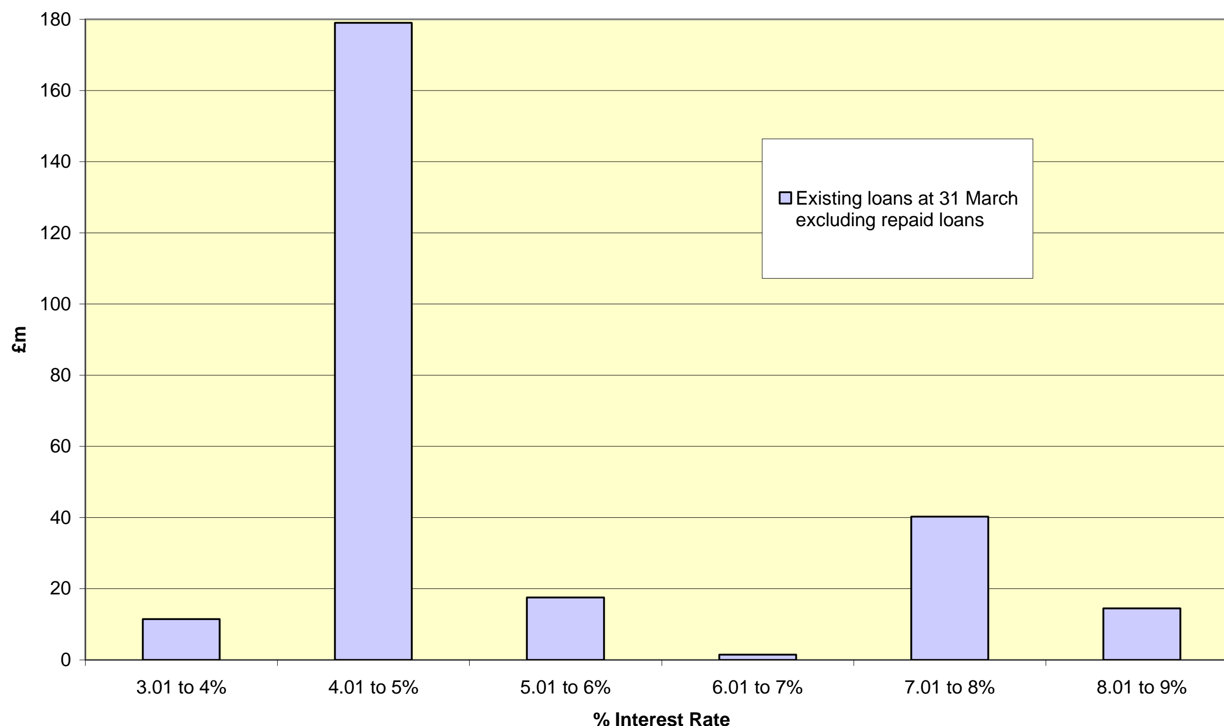
2.1 The County Council has had a strategy to borrow to support the Capital Programme and lend out other cash (rather than using internal borrowing). Historically this meant that the interest rate earned on cash balances was higher than the interest rate paid on loans from the Public Works Loans Board (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 The average interest rate of all debt at 31 March 2012 (£264.2m) was 5.20%.

2.3 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 replaced in February 2012 with market loans of £23m at a rate of 4.39%. The repayments of PWLB loans and the replacement with market loans will result in a total savings of £1.1m over seven years. This was reported in the Stewardship report to Cabinet in June 2010.

2.4 The PWLB increased all of its lending rates in October 2010 (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 2011/12 to date to cover temporary overdraft situations.

4 Treasury Management Advisers

4.1 The Strategy for 2011/12 explained that the County Council uses Sector 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 Sector is the largest provider of Treasury Management advice services to local authorities in the UK and they claim to be the market leading treasury management service provider to their clients. The advice has been and will continue to be monitored regularly to ensure a continued excellent advisory service.

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)

1.2 **Operational and authorised borrowing limits.**

The tables below sets out the estimate and projected capital financing requirement and long-term borrowing in 2011/12

	CAPITAL FINANCING REQUIREMENT	**2011/12**	**2011/12**
		Estimate **£m**	**Likely Actual** **£m**
	Capital financing requirement at 1 April 2011	348*	340*
ADD	Financing of new assets	25	97
LESS	Provision for repayments of debt	-12	-46
		-------	-------
	Capital financing requirement at 31 March 2012	**361***	**391****
ADD	Net borrowing for next year	18	

	Operational boundary	**379**	
ADD	Short term borrowing	20	Nil

	Authorised limit	**399**	

	ACTUAL BORROWING	**2011/12**
		Actual **£m**
	Long term borrowing at 1 April 2011	241.2
ADD	Borrowing in February 2012	23..0
	Long term borrowing at 31 March 2012	**264.2**

* Includes £39m for Private Finance Initiative (PFI) Schemes and Finance Leases.
** Includes £99m for Private Finance Initiative (PFI) Schemes and Finance Leases.

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 2012 of £264m is under the Operational boundary and Authorised limit set for 2011/12. 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 2011/12. 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	2011/12 Estimate	2011/12 Actual
Fixed Rate Exposure		
Upper Limit	100%	100%
Lower Limit *	53%	
Variable Rate Exposure		
Upper Limit	47%	0%
Lower Limit *	0%	

(* assumes all new borrowing is variable)

Lending		
Fixed Rate Exposure		
Upper Limit	100%	66%
Lower Limit	0%	
Variable Rate Exposure		
Upper Limit	100%	34%
Lower Limit	0%	

Borrowing and Lending combined		
Fixed Rate Exposure		
Upper Limit	100%	82%
Lower Limit	26%	
Variable Rate Exposure		
Upper Limit	100%	18%
Lower Limit	0%	

In 2011/12, 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

The new borrowing taken in 2011/12 was a market loan agreed in advance in February 2010 at 4.39% to replace PWLB loans at 4.7%. The average interest rate has reduced from 5.31% on £241.2m at 31 March 2011 to 5.2% on £264.2m at 31 March 2012. No new PWLB loans were taken in 2011/12.

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	Actual at 31.3.2012
Under 12 months	0%	25%	5%
12 months and within 24 months	0%	40%	1%
24 months and within 5 years	0%	60%	13%
5 years and within 10 years	0%	80%	7%
10 years and within 20 years	0%	80%	15%
20 years and within 30 years	0%	80%	10%
30 years and within 40 years	0%	80%	26%
40 years and above	0%	80%	23%

The County Council has not exceeded the limits set in 2011/12.

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. 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.

There has been a recent change to the reporting arrangements under the Treasury Management Code of Practice regarding the maturity structure of debt. The next possible call date has replaced the final maturity date to report when the debt expires. This has increased the amount in certain earlier years and reduced the amount in later years in our comparisons and in one year (2016/17) has exceeded the maximum of £20m of debt in any one year. It does not exceed the other limit of not more than 15% to mature in any two consecutive financial years. In practice, based on previous experience of market loans both for East Sussex and with other local authorities the loan is unlikely to be called.

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 2011/12.

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	206.1	0.95%	0.45%	-0.05%
May	218.4	0.95%	0.45%	-0.05%
June	212.9	0.95%	0.45%	-0.05%
July	225.2	0.93%	0.43%	-0.07%
August	226.1	0.91%	0.41%	-0.09%
September	220.2	0.91%	0.41%	-0.09%
October	226.5	0.92%	0.42%	-0.08%
November	213.8	0.91%	0.41%	-0.09%
December	210.4	0.89%	0.39%	-0.11%
January	214.9	0.88%	0.38%	-0.12%
February	207.6	0.88%	0.38%	-0.12%
March	220.5	0.85%	0.35%	-0.15%
Total for 2011/12	**2.602.6**	**0.91%**	**0.41%**	**-0.09%**

The total amount received in short term interest for the year was £2.6m at an average rate of 0.91%. 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**

The Council's Borrowing Need (the Capital Financing Requirement)

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 but now includes Private Finance Initiative (PFI) Schemes and Finance Leases.

1.11 Following accounting changes the CFR includes other long term liabilities (e.g. PFI schemes and Finance Leases) being brought onto the balance sheet. Whilst this increases the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes. The Council has £99m of PFI and Finance Lease schemes within the CFR as at March 2012.

1.12. The CFR projections are set out below:

£m	2011/12 Likely Actual	2012/13 Estimated	2013/14 Estimated
Total CFR	**391**	**358**	**365**
Movement in CFR	**51**	**6**	**6**

Movement in CFR represented by			
Net financing need for the year (above)	97	19	19
MRP/Voluntary Revenue Provision (VRP) and other financing movements	-46	-13	-13
Movement in CFR	**51**	**6**	**6**

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), although it is also allowed to undertake additional voluntary payments if required (voluntary revenue provision VRP).

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 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 involved 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. The accounting treatment impacted on the Capital Financing Requirement with the result that an annual MRP provision is now required.

1.19 The policy agreed for adoption from 1 April 2010 retained the key elements of the policy previously approved but now incorporated 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