Report to:	**Audit, Best Value & Community Services Scrutiny Committee**
Date:	**5 September 2014**
By:	**Chief Operating Officer**
Title of report:	**Treasury Management – 2013/14 Stewardship/Half Year 2014/15 Report**
Purpose of report:	**To present a review of the County Council's performance on treasury management for the year 2013/14 and Mid Year review for 2014/15.**

RECOMMENDATION: The Audit, Best Value and Community Services Scrutiny Committee is recommended to consider the Treasury Management performance in 2013/14 incorporating the Mid Year review for the first half of 2014/15

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1. Introduction

1.1 The annual stewardship report reviews the Council's treasury management performance and Mid Year report 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 2013/14 and the economic factors affecting this strategy (Appendix A).
- The treasury management activity during the year (Appendix B);
- The treasury management Mid Year activity for 2014/15 (Appendix C);
- The Prudential Indicators, which relate to the Treasury function and compliance with limits (Appendix D).

3. The economic conditions compared to our original Strategy for 2013/14

3.1 The original strategy and the economic conditions prevailing in 2013/14 are set out in Appendix A which is attached to this report. 2013/14 continued the challenging environment of the previous years, with concerns over the states of the UK economy and of European countries. 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 2013/14, agreed in January 2013, 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 (revised to 2 years within the 2014/15 strategy). A more prudent approach was adopted

throughout 2013/14 because of the uncertainties in the market and the emphasis was to be able to pre-empt/react quickly if market conditions worsen.

Short term lending

4.2 The total amount received in short term interest for 2013/14 was £1.35m at an average rate of 0.39%. This was below the average of base rates in the same period (0.5%) and 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 a 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 2013/14 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:

- No new borrowing was undertaking during 2013/14. It was agreed to use "internal borrowing" to finance new capital investment
- The average interest rate of all debt at 31 March 2014 (£262.9m) 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. Treasury Management Mid Year Review 2014/15

5.1 The Treasury Management and Annual Investment Strategy for 2014/15 were approved by the Cabinet 28 January 2014 and there have been no policy changes to date.

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

6.1 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 D.

7. Conclusion and reason for recommendation

7.1 This report updates the Audit, Best Value and Community Services Scrutiny Committee and fulfils the requirement to submit an annual/half yearly report in the form prescribed in the Treasury Management Code of Practice. Short term lending achieved improved returns toward the end of the year. This reflects the objective to ensure so far as possible in the financial climate, a 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 must continue to be able to pre-empt/react quickly if market conditions worsen.

KEVIN FOSTER

Chief Operating Officer

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BACKGROUND DOCUMENTS

Cabinet 26 January 2013 Treasury Management Strategy for 2013/14
28 January 2014 Treasury Management Strategy for 2014/15

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 2013/14 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 in January 2013, 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 2013/14 was drawn up in January 2013, 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 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 2013/14.

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 County Council's past strategy was 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. The average rate of all debt at 31 March 2014 of £262.9m is 5.20% (2012/13 of £264.2m is 5.20%). No new loans have been taken and no beneficial rescheduling of debt has been available

2.2 Our opportunity to restructure our debt has been significantly reduced since October 2010 as a result of the PWLB increasing all of its lending rates by 1% as part of the Government's Comprehensive Spending Review. 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.

2.3 The Council will not borrow purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

3. Investment

3.1 When the strategy was agreed in January of 2013, the advice given to us by our advisors, Capita, was that short term rates were expected to remain on hold for a considerable time. Economic forecasting remained troublesome with so many extermal influences weighing on the UK. There was consensus among analysts that the economy would remain weak and whilst there was still a broad range of views as to potential performance. Key areas of uncertainty included:

- the potential for the Eurozone to withdraw support for Greece at some point if the costs of such support escalate were to become prohibitive, so causing a worsening of the Eurozone debt crisis and heightened risk of the breakdown of the bloc or even of the currency itself;
- inter government agreement on how to deal with the overall Eurozone debt crisis could fragment; the impact of the Eurozone crisis on financial markets and the banking sector;
- the impact of the Government's austerity plan on confidence and growth and the need to rebalance the economy from services to manufactured goods;
- the under-performance of the UK economy which could undermine the Government's policies that have been based upon levels of growth that are unlikely to be achieved;
- the risk of the UK's main trading partners, in particular the EU and US, falling into recession ;
- stimulus packages failing to stimulate growth;
- elections due in Germany in 2013;
- potential for protectionism i.e. an escalation of the currency war / trade dispute between the US and China.
- the potential for action to curtail the Iranian nuclear programme
- the situation in Syria deteriorating and impacting other countries in the Middle East
- the focus of so many consumers, corporates and banks on reducing their borrowings, rather than spending, will continue to act as a major headwind to a return to robust growth in western economies.

The overall balance of risks remained weighted to the downside. Lack of economic growth, both domestically and overseas, would impact on confidence putting upward pressure on unemployment. It would also further knock levels of demand which would bring the threat of recession back into focus.

3.2 Capita believed that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries.

3.3 Given the weak outlook for economic growth, Capita saw the prospects for any interest rate changes before mid-2013 as very limited. There was potential for the start of Bank Rate increases to be even further delayed if growth disappointed.

4. Revised Strategy agreed for 2013/14

4.1 The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the 2011 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sector Asset Services al Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second, and then return. The strategy adopted in the original Treasury Management Strategy Report for 2013/14 approved by the Council on 29 January 2013, was subject to revision during the year due to a review of the Council's treasury management activities and counterparty list.

4.2 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.

4.3 It was recognised that movements within the money markets can happen with no notice and the Chief Finance Officer 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.

4.4 The expectation for interest rates within the strategy for 2013/14 anticipated low but rising Bank Rate (starting in quarter 1 of 2015), and gradual rises in medium and longer term fixed borrowing rates during 2013/14. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

4.5 In this scenario, the treasury strategy was to postpone borrowing to avoid the cost of holding higher levels of investments and to reduce counterparty risk. 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. 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.

4.6 All of the investments were classified as Specified and non-Specified Investments. These investments were sterling investments for up to two years maturity with institutions deemed to be high credit quality or with the UK Government (Debt Management Account Deposit Facility). These were considered low risk assets where the possibility of loss of principal or investment income was small.

4.7 Investment instruments identified for use in the financial year under the 'Non-Specified and Specified' Investments categories. The County Council funds would be invested as follows:-

Specified Investments

4.8 *The use of Specified Investments - Investment instruments identified for use in the financial year are as follows:*

- Table below set out the types of investments that fall into each category, counterparties available to the Council, and the limits placed on each of these. A detailed list of each investment type is available in the Treasury Management Practices guidance notes;
- all investments will be within the UK or AAA sovereign rated countries.
- The Council's investments in Lloyds Banking Group were based on the fact that this group is part-nationalised by UK Government, and any changes to their credit ratings will impact on the duration of the Council investment with the Group.

Counterparty	Country/Domicile	Instrument	Maximum investments	Max. maturity period
Debt Management and Depost Facilities (DMADF)	UK	Term Deposits	unlimited	12 months
Government Treasury blls	UK	Term Deposits	unlimited	12 months
Local Authorities	UK	Term Deposits	unlimited	12 months
RBS/NatWest Group • *Royal Bank of Scotland* • *NatWest*	UK	Term Deposits (including callable deposits), Certificate of	£60m	1 yr
Lloyds Banking Group • *Lloyds Bank*	UK		£60m	1 yr

Counterparty	Country/Domicile	Instrument	Maximum investments	Max. maturity period
• *Bank of Scotland*		Deposits		
Barclays	UK		£60m	1 yr
Santander UK	UK		£60m	1 yr
HSBC	UK		£60m	1 yr
Individual Money Market Funds	UK/Ireland/ domiciled	AAA rated Money Market Funds	£60m	Liquidity/instant access
Counterparties in select countries (non-UK) with a Sovereign Rating of at least AAA				
Australia & New Zealand Banking Group	Australia	Term Deposits/Call Accounts	£60m	1 yr
Commonwealth Bank of Australia	Australia	Term Deposits/Call Accounts	£60m	1 yr
National Australia Bank	Australia	Term Deposits/Call Accounts	£60m	1 yr
Westpac Banking Corporation	Australia	Term Deposits/Call Accounts	£60m	1 yr
Royal Bank of Canada	Canada	Term Deposits/Call Accounts	£60m	1 yr
Toronto Dominion	Canada	Term Deposits/Call Accounts	£60m	1 yr
Nordea Bank Finland	Finland	Term Deposits/Call Accounts	£60m	1 yr
Cooperatieve Centrale Raiffeisen Boerenlleenbank BA	Netherlands	Term Deposits/Call Accounts	£60m	1 yr
Development Bank of Singapore	Singapore	Term Deposits/Call Accounts	£60m	1 yr
Oversea Chinese Banking Corp	Singapore	Term Deposits/Call Accounts	£60m	1 yr
United Overseas Bank	Singapore	Term Deposits/Call Accounts	£60m	1 yr
Svenska Handelsbanken	Sweden	Term Deposits/Call Accounts	£60m	1 yr
Nordea Bank AB	Sweden	Term Deposits/Call Accounts	£60m	1 yr

Non Specified Investments

4.9 Non-Specified investments are any other type of investment (i.e. not defined as specified above). The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out in Table below. Non specified investments would include any sterling investments.

Non-Specified Investment	Minimum credit criteria	Maximum investments	Max. maturity period
UK Local Authorities	Government Backed	£60m	2 years

4.10 The Council continues to recognise that movements within the money markets can happen with no notice and the Chief Finance Officer would have to amend the strategy in order to safeguard Council funds. As in the past any such actions would be reported to the next Cabinet meeting.

4.11 Additional requirements under the Code of Practice require the Council to supplement credit rating information. Whilst the above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information has been and will 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 Capita 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.

4.12 All Money Market Funds used are monitored and chosen by the size of fund, rating agency recommendation, exposure to other Countries (Sovereign debt), weighted average maturity and weighted average life of fund investment and counterparty quality.

5. The Economy and Interest Rates in 2013/14

5.1 The financial year 2013/14 continued the challenging investment environment of previous years, namely low investment returns, although levels of counterparty risk had subsided somewhat. The original expectation for 2013/14 was that Bank Rate would not rise during the year and for it only to start gently rising from quarter 1 2015. This forecast rise has now been pushed back to a start in quarter 3 2015. Economic growth (GDP) in the UK was virtually flat during 2012/13 but surged strongly during the year. Consequently there was no additional quantitative easing during 2013/14 and Bank Rate ended the year unchanged at 0.5% for the fifth successive year. While CPI inflation had remained stubbornly high and substantially above the 2% target during 2012, by January 2014 it had, at last, fallen below the target rate to 1.9% and then fell further to 1.7% in February. It is also expected to remain slightly below the target rate for most of the two years ahead.

5.2 Gilt yields were on a sharply rising trend during 2013 but volatility returned in the first quarter of 2014 as various fears sparked a flight to quality. The Funding for Lending Scheme, announced in July 2012, resulted in a flood of cheap credit being made available to banks which then resulted in money market investment rates falling drastically in the second half of that year and continuing into 2013/14. That part of the Scheme which supported the provision of credit for mortgages was terminated in the first quarter of 2014 as concerns rose over resurging house prices.

5.3 The UK coalition Government maintained its tight fiscal policy stance but recent strong economic growth has led to a cumulative, (in the Autumn Statement and the March Budget), reduction in the forecasts for total borrowing, of £97bn over the next five years, culminating in a £5bn surplus in 2018-19.

5.4 The EU sovereign debt crisis subsided during the year and confidence in the ability of the Eurozone to remain intact increased substantially. Perceptions of counterparty risk improved after the ECB statement in July 2012 that it would do “whatever it takes” to support struggling Eurozone countries; this led to a return of confidence in its banking system which has continued into 2013/14 and led to a move away from only very short term investing. However, this is not to say that the problems of the Eurozone, or its banks, have ended as the zone faces the likelihood of weak growth over the next few years at a time when the total size of government debt for some nations is likely to continue rising. Upcoming stress tests of Eurozone banks could also reveal some areas of concern.

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 2013/14. The rate is the lowest ever rate and the rate has remained unchanged for the longest period on record. The last change was over five 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 5 of Appendix A.

1.3 Additional market information including Sovereign ratings, Credit Default Swaps, equity prices, the Capita 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 2013/14, agreed in January 2013, continued the prudent approach and ensured that all investments were only to the highest quality rated banks and only up to a period of up to two years.

1.5 The total amount received in short term interest for 2013/14 was £1.35m at an average rate of 0.39%. This was below the average of base rates in the same period (0.5%) and against a backdrop of ensuring, so far as possible in the financial climate, the security of principal and the minimisation of risk. This base rates return improved slightly towards the end of the financial year as a result of implementing a revised strategy approved in January 2014.

2. Long term borrowing

2.1 The County Council has had a strategy to borrow to support the Capital Programme and lend out surplus cash. 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. The cost of new borrowing is now well in excess of the rate achievable on our investments.

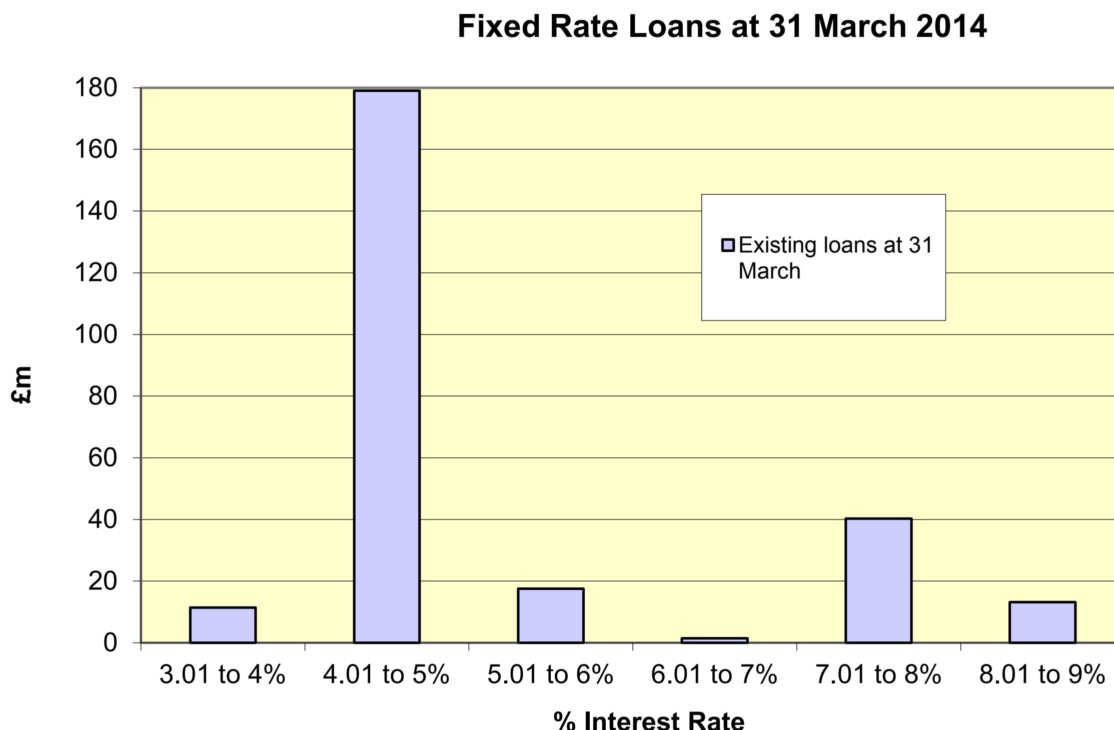
2.2 Given the current low rates of interest available, the Council has given consideration to possible future tranches of borrowing. In the short term this may lead to a 'cost of carry' as the interest rate on debt is higher than the rate at which we are earning interest on investments. However, from a medium to long term perspective, borrowing at these levels will save the Council many millions of pounds as forecasts for borrowing rates increase due to inflationary pressures in the system.

2.3 The average interest rate of all debt at 31 March 2014 of £262.9m was 5.20%.

2.4 Opportunities for cost effective repayment of existing debt and restructuring opportunities were constantly monitored but none emerged in the first six months of the year.

2.5 In the autumn of last year, the Department of Communities and Local Government asked local authorities to make a return to enable them to benefit from a small reduction in all of the PWLB rates for new loans. The PWLB "certainty rate" as it has been named reduced PWLB borrowing rates by 0.20% for most local authorities from November 2012. A return was submitted to keep our options open but despite this reduction, East Sussex did not borrow as the long term benefit did not exceed the short term costs.

2.6 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 2013/14 to date to cover temporary overdraft situations.

4 Treasury Management Advisers

4.1 The Strategy for 2013/14 explained that the County Council uses Capita 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 Capita 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

The Treasury Management Activity Mid-Year Report - 2014/15

1. Background

1.1 As part of the County Council's governance arrangements for its treasury management activities, the Audit, Best Value and Community Services Scrutiny Committee is charged with oversight of the County Council's treasury management activities. To enable the Committee to fulfil this role, the Committee receives regular reports on treasury management issues and activities. Reports on treasury activity are discussed on a monthly basis with the Chief Finance Officer and the content of these reports is used as a basis for this report to the Committee.

1.2 The Treasury Management and Annual Investment Strategy for 2014/15 were approved by the Cabinet 28 January 2014 and there have been no policy changes to date. This report considers treasury management activity over the first quarter months of the financial year.

Summary of financial implications

1.3 The level of Council debt at June 2014 is currently £262.9m with two loans totalling £2.6m maturing with the PWLB in September 2014. The forecast for interest paid on long-term debt in 2014/15 is approximately £13.6m and is within the budgeted provision. The average balance of investments of approximately £383m generated investments income of £560k to June 2014. The forecast for 2014/15 is £2.0m, exceeding the previous year outturn of £1.35m.

2. Treasury Management Strategy

2.1 The Council approved the 2014/15 treasury management strategy at its meeting on 28 January 2014. The Council's stated investment strategy is to prudently manage an investment policy achieving first of all, security (protecting the capital sum from loss), liquidity (keeping money readily available for expenditure when needed), and to consider what yield can be obtained consistent with those priorities.

2.2 The Council's exposure to security and interest rate risk could have been reduced by repaying some of the £262.9m outstanding long-term debt as at 30 June 2014, and, where possible, by rescheduling the average maturity of the loans. However under the current economic conditions the costs of doing so in terms of interest and premium payable would be prohibitive.

2.3 The Chief Finance Officer is pleased to report that all treasury management activity undertaken from 1 April to 30 June 2014 period broadly complied with the approved strategy, the CIPFA Code of Practice, and the relevant legislative provisions.

3. Economic Review

3.1 After strong UK GDP growth of 0.7%, 0.8% and 0.7% in quarters 2, 3 and 4 respectively in 2013, and 0.8% in Q1 2014, it appears very likely that strong growth will continue into 2014 as forward surveys are very encouraging. There are also positive indications that recovery is starting to broaden away from reliance on consumer spending and the housing market into construction, manufacturing, business investment and exporting. This strong growth has resulted in unemployment falling much faster through the threshold of 7%, set by the Monetary Policy Committee (MPC) last August, before it said it would consider any increases in Bank Rate. The MPC has, therefore, now broadened its forward guidance by adopting five qualitative principles and looking at a much wider range of about eighteen indicators in order to form a view on how much slack there is in the economy and how quickly slack is being used up. Accordingly, markets are expecting a first increase around the end of 2014.

3.2 Also encouraging has been the sharp fall in inflation (CPI), reaching 1.5% in May, the lowest rate since 2009. Forward indications are that inflation is likely to fall further in 2014 to possibly 1%. The return to strong growth has also helped lower forecasts for the increase in Government debt by

£73bn over the next five years, as announced in the Autumn Statement, and by an additional £24bn, as announced in the March 2014 Budget - which also forecast a return to a significant budget surplus, (of £5bn), in 2018-19. However, monthly public sector deficit figures have disappointed in this quarter.

3.3 In June, the Federal Reserve continued with its monthly $10bn reductions in asset purchases, which started in December 2014. Asset purchases have now fallen from $85bn to $35bn and are expected to stop by Q3 201, providing strong economic growth continues this year. First quarter GDP figures were depressed by exceptionally bad winter weather, but growth rates since then look as if they are recovering well.

3.4 The Eurozone is facing an increasing threat from deflation. In May, the inflation rate fell further, to reach 0.5%. However, this is an average for all EZ countries and includes some countries with negative rates of inflation. Accordingly, the ECB did take some rather limited action in June to loosen monetary policy in order to promote growth.

Interest Rate Forecast

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

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

Capita Asset Services undertook a review of its interest rate forecasts in May, after the Bank of England's Inflation Report. However, more recent developments to the Bank of England's forward guidance have necessitated a second updating in this quarter carried out on 30 June. This latest forecast now includes a first increase in Bank Rate in quarter 1 of 2015 (previously quarter 4 of 2015).

3.6 Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth rebounded during 2013 and the first quarter of 2014 to surpass all expectations, propelled by recovery in consumer spending and the housing market. Forward surveys are currently very positive in indicating that growth prospects are also strong for the rest of 2014, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. This is very encouraging as there does need to be a significant rebalancing of the economy away from consumer spending to construction, manufacturing, business investment and exporting in order for this start to recovery to become more firmly established.

Appendix D

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 2013/14

	CAPITAL FINANCING REQUIREMENT	**2013/14**	**2013/14**	**2013/14**
		Estimate £m	**Revised Estimate £m**	**Estimated Actual £m**
	Capital financing requirement at 1 April 2013	396	387	387
ADD	Financing of new assets	21	-	-
LESS	Provision for repayments of debt	-16	-17	-15
		-------	-------	-------
	Capital financing requirement at 31 March 2014	**401**	**370**	**372**
ADD	Net borrowing for next year	54	10	
		-------	-------	
	Operational boundary	**455**	**380**	
ADD	Short term borrowing	20	20	Nil
		-------	-------	
	Authorised limit	**475**	**400**	

	ACTUAL BORROWING	**2013/14**
		Actual £m
	Long term borrowing at 1 April 2013	264.2
LESS	Loan redemption	-1.3
	Long term borrowing at 31 March 2014	**262.9**

The Capital Financing Requirement includes PFI Schemes and Finance Leases.

A revised Authorised Limit for 2013/14 of £400m reflected the move to International Financial Reporting Standards (IFRS) and previously agreed 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 impacted on the Authorised Limit.

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 2014 of £262.9m is under the Operational boundary and Authorised limit set for 2013/14. 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 2013/14. 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	2013/14 Estimate	2013/14 Actual
Fixed Rate Exposure		
Upper Limit	100%	85%
Lower Limit *	85%	
Variable Rate Exposure		
Upper Limit	15%	15%
Lower Limit *	0%	

(* assumes all new borrowing is variable)

Lending		
Fixed Rate Exposure		
Upper Limit	100%	56%
Lower Limit	0%	
Variable Rate Exposure		
Upper Limit	100%	44%
Lower Limit	0%	

Borrowing and Lending combined		
Fixed Rate Exposure		
Upper Limit	100%	75%
Lower Limit	27%	
Variable Rate Exposure		
Upper Limit	100%	25%
Lower Limit	0%	

In 2013/14, borrowing has continued to be at a fixed rate. The County Council has no variable rate loans. Our lending has been both at fixed rates (to Banks and the Debt Management Office (DMO)) and variable rates (to 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 2013/14.

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 2013/14
Under 12 months	0%	25%	6%
12 months and within 24 months	0%	40%	2%
24 months and within 5 years	0%	60%	14%
5 years and within 10 years	0%	80%	8%
10 years and within 20 years	0%	80%	16%
20 years and within 30 years	0%	80%	15%
30 years and within 40 years	0%	80%	30%
40 years and above	0%	80%	10%

The County Council has not exceeded the limits set in 2013/14.

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 1 shows the maturity profile.

1.6 Maturity structure of investments

The Investment Guidance issued by the government, 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 and non-Specified Investments are allowed to be 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 2013/14.

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**

1.8.1. 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 against Base Rate
April	140.7	0.50%	0.00%
May	129.0	0.41%	-0.09%
June	103.9	0.34%	-0.16%
July	107.9	0.34%	-0.16%
August	103.8	0.33%	-0.17%
September	101.1	0.34%	-0.16%
October	100.7	0.35%	-0.15%
November	91.7	0.34%	-0.16%
December	104.6	0.34%	-0.16%
January	107.7	0.40%	-0.10%
February	112.5	0.47%	-0.03%
March	147.0	0.54%	0.04%
Total for 2013/14	**1.350.6**	**0.39%**	**-0.11%**

1.8.2. The total amount received in short term interest for the year was £1.35m at an average rate of 0.39%. This was above the average of base rates in the same period (0.5%) but ensuring, so far as possible in the financial climate, the security of principal and the minimisation of risk. This Council has continued to follow a prudent approach with security and liquidity as the main criteria before yield.

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

1.9.1. The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's indebtedness. The CFR results from the capital activity of the Council and resources used to pay for the capital spend. It represents the 2013/14 unfinanced capital expenditure (see below table), and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

1.9.2. Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure that sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies (such as the Government, through the Public Works Loan Board [PWLB] or the money markets), or utilising temporary cash resources within the Council.

1.9.3. Reducing the CFR – the Council's underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision – MRP, to reduce the CFR. This is effectively a repayment of the borrowing need. This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

1.9.4 The total CFR can also be reduced by:

- the application of additional capital financing resources (such as unapplied capital receipts); or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

1.9.5. The Council's 2013/14 MRP Policy (as required by CLG Guidance) was approved as part of the Treasury Management Strategy Report for 2013/14 on 29 January 2013.

1.9.6. The Council's CFR for the year is shown below, and represents a key prudential indicator. It includes PFI and leasing schemes on the balance sheet, which increase the Council's borrowing need. No borrowing is actually required against these schemes as a borrowing facility is included in the contract.
CFR including appropriate balances and MRP charges for PFI Schemes and Finance Leases.

	2013/14 Actual	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
	£m	£m	£m	£m
Total CFR	**372**	**360**	**395**	**390**
Movement in CFR	**-15**	**-12**	**35**	**-5**

Movement in CFR represented by				
Net financing need for the year (above)	-	3	50	9
MRP/VRP and other financing movements	-15	-15	-15	-14
Movement in CFR	**-15**	**-12**	**-35**	**-5**

Minimum Revenue Provision (MRP) Statement

1.10 The statutory requirement for local authorities to charge the Revenue Account each year with a specific sum for debt repayment has been replaced with a more flexible statutory guidance and a variety of options is provided to councils to replace the existing Regulations, so long as there is a prudent provision.

1.11 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).

1.12 To support the statutory duty the Government also issued a guidance, which required 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.

1.13 The MRP guidance offered 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).

1.14 The move to International Financial Reporting Standards (IFRS) 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. This accounting treatment impacted on the Capital Financing Requirement with the result that an annual MRP provision will be required.

1.15 The policy recommended for adoption from 1 April 2013 retained 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. The policy adopted for 2013/14 is therefore as follows:-

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

- 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.

1.17 From 1 April 2008 for all unsupported borrowing the MRP policy has been:

- Asset Life Method – MRP will be based on the estimated life of the assets, in accordance with the proposed regulations (this option will be applied for any expenditure capitalised under a Capitalisation Direction).

- 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).

Annex 1