Report to:	**Cabinet**
Date:	**15 November 2016**
By:	**Chief Operating Officer**
Title of report:	**Treasury Management – Stewardship Report 2015/16**
Purpose of report:	**To present a review of the Council's performance on treasury management for the year 2015/16 and Mid Year review for 2016/17, and no changes to the Treasury Management Policy and Strategy are recommended.**

RECOMMENDATION: The Cabinet is recommended to note the Treasury Management performance in 2015/16 incorporating the Mid Year review for the first half of 2016/17

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1. Background

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 Council's treasury management activities are regulated by a variety of professional codes and statutes and guidance. The 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 2015/16 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 2016/17 (Appendix C);
- The Prudential Indicators, which relate to the Treasury function, Minimum Revenue Policy (MRP) and compliance with limits (Appendix D).

3. The economic conditions compared to our Strategy for 2015/16

3.1The strategy and the economic conditions prevailing in 2015/16 are set out in Appendix A which is attached to this report. 2015/16 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 2015/16, agreed in January 2015, continued the prudent approach and ensured that all investments were only to the highest quality rated banks and only up to a period of two years. A more prudent approach was adopted throughout 2015/16 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 2015/16 was £2.2m at an average rate of 0.73%. This was above the average base rates in the same period (0.50%) 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.

Long term borrowing

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

- Total of £20m borrowed during 2015/16 from the Public Works Loan Board (PWLB) for a 15-16 year fixed maturity period at an average rate of 2.75%.
- The average interest rate of all debt at 31 March 2016 (£275m) was 5.03%.
- Although a proactive approach has been taken to repayment and restructuring of debt, no cost effective opportunities arose during the year, because there has been a considerable widening of the difference between new borrowing and repayment rates, which has made PWLB debt restructuring now much less attractive.

5. Treasury Management Mid Year Review 2016/17

5.1 The Treasury Management and Annual Investment Strategy for 2016/17 were approved by the Cabinet on 26 January 2016, the average rate of return for investments to 30 September 2016 was 0.70%.

5.2 Further PWLB borrowing of £5m was undertaken in June 2016 for a 20 year fixed maturity period again at an attractive rate of 2.71%.

5.3 During 2016/17 debt to be repaid to the PWLB totals £4.6m, this historic debt is at an average rate of 8.2%.

5.4 The Minimum Revenue Provision is under review with an update to follow within the financial year.

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

6.1 The 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 Cabinet 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 throughout the year saw returns increase steadily from 0.66% to 0.73%. 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.

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BACKGROUND DOCUMENTS

Cabinet 27 January 2015 Treasury Management Strategy for 2015/16
26 January 2016 Treasury Management Strategy for 2016/17

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 2015/16 and the economic factors affecting this strategy

1. Background information

1.1 Cabinet receive an annual Treasury Management Strategy report in January 2015, 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 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 2015/16 was drawn up in January 2015, the money markets were still concerned about global credit events. 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 2015/16.

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 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. Investment

2.1 When the strategy was agreed in January 2015, it emphasised the continued importance of taking account of the current and predicted future state of the financial sector. The Treasury Management advisors (Capita Asset Services) commented on short term interest rates, the UK economy, inflation, the outlook for long term interest rates and these factors were taken into account when setting the strategy.

2.3 Officers regularly review the investment portfolio, counterparty risk and construction, and use market data, information on government support for banks and the credit ratings of that government support. Latest market information is arrived at by reading the financial press and through city contacts as well as access to the key brokers involved in the London money markets.

2.4 This Council in addition to other tools uses the creditworthiness service provided by Capita Asset Services. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody's and Standard and Poor's. The credit ratings of counterparties are supplemented with the following overlays:

- credit watches and credit outlooks from credit rating agencies;
- credit default swap (CDS) spreads to give early warning of likely changes in credit ratings; and

- sovereign ratings to select counterparties from only the most creditworthy countries.

2.4 The strategy going forward was to continue with the policy of ensuring minimum risk but was also intended to deliver secure investment income of at least bank rate on the Councils cash balances.

2.5 As was clear from the events globally and nationally since 2008, it is impossible in practical terms to eliminate all credit risk.

2.6 The strategy aimed to ensure that in the economic climate it was essential that a prudent approach was maintained. This would be achieved through investing with selected banks and funds which met the Council's rating criteria. The emphasis would continue on security (protection of the capital sum invested) and liquidity (keeping money readily available for expenditure when needed) rather than yield.

2.7 The Council's investment policy has regard to the DCLG's Guidance on Local Government Investments ("the Guidance") and the 2011 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Capita Asset Services al Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second, and then return.

2.8 Investment instruments identified for use in the financial year are listed in section 3.2 and 3.4 under the 'Specified and Non-Specified' Investments categories. Counterparty limits will be as set through the Council's Treasury Management Practices – Schedules.

2.9 The weighted scoring system produces an end product of a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the suggested duration for investments, i.e., using counterparties within the following durational bands provided they have a minimum AA+ sovereign rating from three rating agencies:

- Yellow 2 years
- Purple 2 years
- Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange 1 year
- Red 6 months
- Green 3 months
- No Colour, not to be used

Y	*P*	*B*	*O*	*R*	*G*	*N/C*
Up to 2yrs	*Up to 2yrs*	*Up to 1yr*	*Up to 1yrs*	*Up to 6 mths*	*Up to 100days*	*No Colour*

The Capita Asset Services credit worthiness service uses a wider array of information than just primary ratings and by using a risk weighted scoring system, does not give undue influence to just one agency's ratings.

Typically the minimum credit ratings criteria the Authority use, will be a short term rating (Fitch or equivalents) of short term rating F1, long term rating A-, viability rating of A-, and a support rating of 1. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.
All credit ratings will be monitored daily. The Authority is alerted to changes to ratings of all three agencies through its use of the Capita Asset Services credit worthiness service.

- if a downgrade results in the counterparty or investment scheme no longer meeting the Authority's minimum criteria, its further use as a new investment will be withdrawn immediately.
- in addition to the use of credit ratings the Authority will be advised of information in movements in Credit Default Swap against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Authority's lending list.

The Capita Asset Services methodology was revised in October 2015 and determines the maximum investment duration under the credit rating criteria. Key features of Capita Asset Services credit rating policy are:

- a mathematical based scoring system is used taking ratings from all three credit rating agencies;
- negative and positive watches and outlooks used by the credit rating agencies form part of the input to determine a counterparty's time band (i.e. 3, 6, 9, 12 months etc.).
- CDS spreads are used in Capita Asset Services creditworthiness service as it is accepted that credit rating agencies lag market events and thus do not provide investors with the most instantaneous and "up to date" picture of the credit quality of a particular institution. CDS spreads provide perceived market sentiment regarding the credit quality of an institution.
- After a score is generated from the inputs a maximum time limit (duration) is assigned and this is known as the Capita Asset Services colour which is associated with a maximum suggested time boundary.

2.10 All of the investments were classified as Specified (i.e., investment is sterling denominated and has a maximum maturity of 1 year) and non-Specified Investments (i.e., any other type of investment not defined as Specified). 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.

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

3. Specified Investments

3.1 An investment is a specified investment if all of the following apply:

- the investment is denominated in sterling and any payments or repayments in respect of the investment are payable only in sterling;
- the investment is not a long term investment (i.e. up to 1 year);
- the making of the investment is not defined as capital expenditure by virtue of regulation 25(1)(d) of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 [SI 3146 as amended];
- the investment is made with a body or in an investment scheme of high credit quality (see below) or with one of the following public-sector bodies:
    - The United Kingdom Government;
    - A local authority in England or Wales (as defined under section 23 of the 2003 Act) or a similar body in Scotland or Northern Ireland; and
    - High credit quality is defined as a minimum credit rating as outlined in section 4.2 of this strategy.

3.2 The use of Specified Investments

Investment instruments identified for use in the financial year are as follows:

- The 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.

Criteria for specified Investments:

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 Deposits	£60m	1 yr
Lloyds Banking Group • *Lloyds Bank* • *Bank of Scotland*	UK		£60m	1 yr
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

3.3 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.

Non Specified Investments

3.4 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 the 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

3.5 The council had no exposure in Non-Specified investments during the 2015/16.

4. The economy in 2015/16 – Commentary from Capita Asset Services (Treasury Management Advisors) in May 2016.

4.1 Market expectations for the first increase in Bank Rate moved considerably during 2015/16, starting at quarter 3 2015 but soon moving back to quarter 1 2016. However, by the end of the year, market expectations had moved back radically to quarter 2 2018 due to many fears including concerns that China's economic growth could be heading towards a hard landing; the potential destabilisation of some emerging market countries particularly exposed to the Chinese economic slowdown; and the continuation of the collapse in oil prices during 2015 together with continuing Eurozone growth uncertainties.

4.2 These concerns have caused sharp market volatility in equity prices during the year with corresponding impacts on bond prices and bond yields due to safe haven flows. Bank Rate, therefore, remained unchanged at 0.5% for the seventh successive year. Economic growth (GDP) in the UK surged strongly during both 2013/14 and 2014/15 to make the UK the top performing advanced economy in 2014. However, 2015 has been disappointing with growth falling steadily from an annual rate of 2.9% in quarter 1 2015 to 2.1% in quarter 4.

4.3 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 materially. These rates continued at very low levels during 2015/16.

4.4 The sharp volatility in equity markets during the year was reflected in sharp volatility in bond yields. However, the overall dominant trend in bond yields since July 2015 has been for yields to fall to historically low levels as forecasts for inflation have repeatedly been revised downwards and expectations of increases in central rates have been pushed back. In addition, a notable trend in the year was that several central banks introduced negative interest rates as a measure to stimulate the creation of credit and hence economic growth.

4.5 The ECB had announced in January 2015 that it would undertake a full blown quantitative easing programme of purchases of Eurozone government and other bonds starting in March at €60bn per month. This put downward pressure on Eurozone bond yields. There was a further increase in this programme of QE in December 2015. The anti-austerity government in Greece, elected in January 2015 eventually agreed to implement an acceptable programme of cuts to meet EU demands after causing major fears of a breakup of the Eurozone. Nevertheless, there are continuing concerns that a Greek exit has only been delayed.

4.6 The UK elected a majority Conservative Government in May 2015, removing one potential concern but introducing another due to the promise of a referendum on the UK remaining part of the EU. The government maintained its tight fiscal policy stance but the more recent downturn in expectations for economic growth has made it more difficult to return the public sector net borrowing to a balanced annual position within the period of this parliament.

Appendix B

The Treasury Management activity during the year 2015/16

1. Short term lending interest rates

1.1 Base interest rate remained at 0.50% throughout 2015/16. 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 4 of Appendix A.

1.3 The strategy for 2015/16, agreed in January 2015, continued the prudent approach and ensured that all investments were only to the highest quality rated banks using Capita's colour coded credit methodology.

1.4 The total amount received in short term interest for 2015/16 was £2.2m at an average rate of 0.73%. This was above 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.

2. Long term borrowing

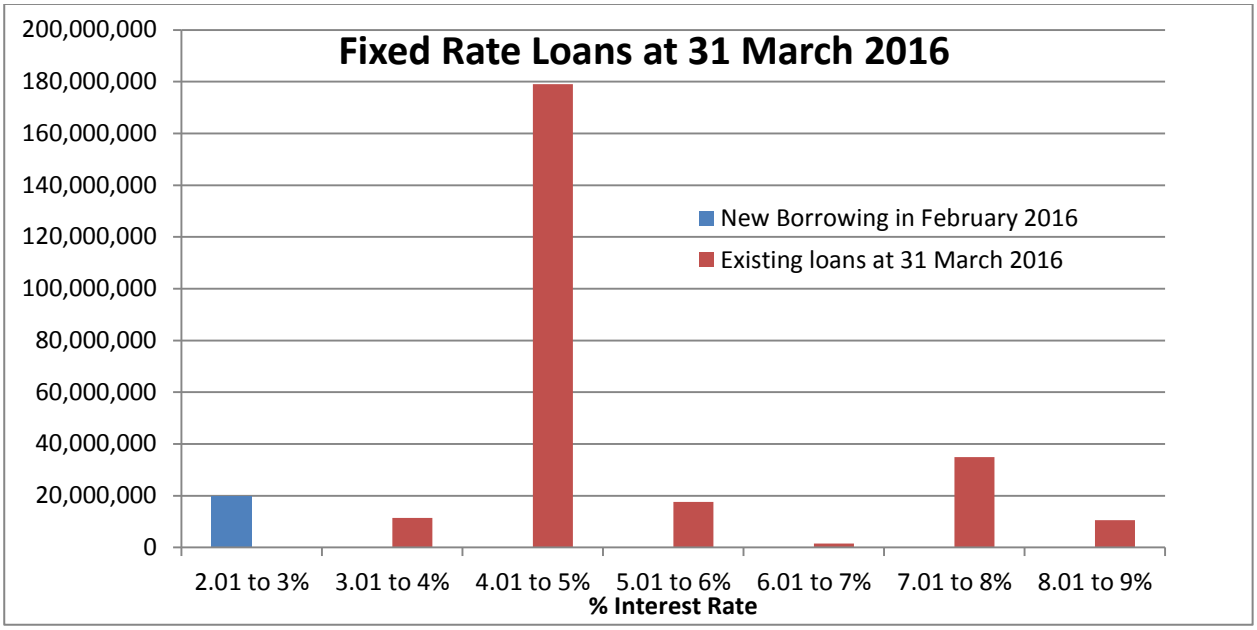
2.1 The Council's strategy was to maintain external borrowing below the level of the CFR – known as internal borrowing. However in the financial climate of low interest rates Officers constantly reviewed the need to borrow taking into consideration the potential increases in borrrowing costs, the need to finance new capital expenditure, refinancing maturing debt, and the cost of carry that might incur a revenue loss between borrowing costs and investment returns.

2.2 In February 2016 the Council took advantage of attractive PWLB rates and borrowed £20m in order to generate cash for the future capital programme. This fixed term borrowing was in the 15 to 16 maturity period the average rate taken was 2.75% with £10m maturing in 2031 and 2032 respectively.

2.3 The average interest rate of all debt at 31 March 2016 of £275m was 5.03%. No beneficial rescheduling of debt has been available, due to a considerable widening of the difference between new borrowing and repayment rates, which has made PWLB debt restructuring now much less attractive. Consideration would have to be given to the large premiums (cash payments) which would be incurred by prematurely repaying existing PWLB loans. It is very unlikely that these could be justified on value for money grounds if using replacement PWLB refinancing.

2.4 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.

2.5 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 2015/16 to date to cover temporary overdraft situations.

4 Treasury Management Advisers

4.1 The Strategy for 2015/16 explained that the 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 - 2016/17

1. Background

1.1 As part of the Council's governance arrangements for its treasury management activities, the Audit, Best Value and Community Services Scrutiny Committee is charged with oversight of the 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 2016/17 were approved by the Cabinet 26 January 2016 and there have been no policy changes to date. This report considers treasury management activity over six months of the financial year.

Summary of financial implications

1.3 In June 2016 the Council borrowed a further £5m from the Public Works Loan Board (PWLB). The term was a 20 years fixed loan at a rate of 2.71%. Record low borrowing rates have been made available due to the fall in UK Gilt yields following market nervousness around macro economic factors and subsequent flight to quality for investors seeking safe havens.

1.4 The level of Council debt at 30 September 2016 was £277.4m with one loan totalling £1.98m maturing with the PWLB on 31 December 2016. The forecast for interest paid on long-term debt in 2016/17 is approximately £13.5m and is within the budgeted provision. The average balance of investments of approximately £290m generated investments income of £1m to September 2016. The forecast for 2016/17 is £1.8m.

2. Treasury Management Strategy

2.1 The Council approved the 2016/17 treasury management strategy at its meeting on 26 January 2016. 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 taking advantage of record low borrowing rates from the PWLB in total £25m since February 2016. Rescheduling any existing loans 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 April 2016 to September 2016 period broadly complied with the approved strategy, the CIPFA Code of Practice, and the relevant legislative provisions.

3. Economic Review

3.1 The Bank of England May Inflation Report included a forecast for growth for 2016 of 2.0% and 2.3% for 2017 on the assumption that the referendum result was a vote to remain. The Governor of the Bank of England, Mark Carney, warned that a vote for Brexit would be likely to cause a slowing in growth, particularly from a reduction in business investment, due to the uncertainty of whether the UK would have continuing full access, (i.e. without tariffs), to the EU single market. In his 30 June and 1 July speeches, Carney indicated that the Monetary Policy Committee (MPC), would be likely to cut Bank Rate and would consider doing further quantitative easing purchasing of gilts, in order to support growth.

3.2 The Inflation Report forecast was notably subdued with inflation barely getting back up to the 2% target within the 2-3 year time horizon. However, the falls in the price of oil and food twelve months ago will be falling out of the calculation of CPI during 2016 and in addition, the recent 10% fall in the value of sterling is likely to result in a 3% increase in CPI over a time period of 3-4 years. There is therefore likely to be an acceleration in the pace of increase in inflation which could make life interesting for an MPC which wants to help promote growth in the economy by keeping Bank Rate low.

3.3 The American economy had a patchy 2015 – quarter 1 0.6% (annualised), 3.9% in quarter 2, 2.0% in quarter 3 and 1.4% in quarter 4, leaving growth in 2015 as a whole at 2.4%. Quarter 1 of 2016 came in at +1.1% but forward indicators are pointing towards a pickup in growth in the rest of 2016. The Fed embarked on its long anticipated first increase in rates at its December meeting. At that point, confidence was high that there would then be four more increases to come in 2016. Since then, more downbeat news on the international scene and then the Brexit vote, has caused a re-emergence of caution over the timing and pace of further increases. It is likely there will now be only one more increase in 2016.

3.4 In the Eurozone, the ECB commenced in March 2015 its massive €1.1 trillion programme of quantitative easing to buy high credit quality government and other debt of selected EZ countries at a rate of €60bn per month; this was intended to run initially to September 2016. In response to a continuation of weak growth, at the ECB's December meeting, this programme was extended to March 2017 but was not increased in terms of the amount of monthly purchases. At its December and March meetings it progressively cut its deposit facility rate to reach -0.4% and its main refinancing rate from 0.05% to zero. At its March meeting, it also increased its monthly asset purchases to €80bn. This programme of monetary easing has had a limited positive effect in helping a recovery in consumer and business confidence and a start to some improvement in economic growth. GDP growth rose by 0.6% in quarter 1 2016 (1.7% y/y) and is expected to continue growing but at only a modest pace. The ECB is also struggling to get inflation up from near zero towards its target of 2%.

Interest Rate Forecast

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

	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Bank rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.50%	0.50%	0.50%
5yr PWLB rate	1.00%	1.10%	1.10%	1.10%	1.10%	1.10%	1.10%	1.20%	1.20%	1.20%	1.30%	1.30%
10yr PWLB rate	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.70%	1.80%	1.80%	1.80%	1.80%	1.90%
25yr PWLB rate	2.40%	2.40%	2.40%	2.50%	2.50%	2.50%	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%
50yr PWLB rate	2.20%	2.20%	2.20%	2.30%	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%

3.6 CAS stated it undertook a quarterly review of its interest rate forecasts on 4 July 2016 after letting markets settle down somewhat after the Brexit result of the referendum on 23 June. It is generally agreed that this outcome will result in a slowing in growth in the second half of 2016 at a time when the Bank of England has only limited ammunition in its armoury to promote growth by using monetary policy. CAS therefore expect that Bank Rate will be cut by 0.25%, by quarter 2 of 2016 when the BOE has a greater opportunity to report in depth on its research and findings.

3.7 Bank Rate could even be cut to 0% or 0.10% over 2016/17. Thereafter, CAS do not expect the MPC to take any further action on Bank Rate in 2016 or 2017 as we expect the pace of recovery of growth to be weak during a period of great uncertainty as to the final agreement between the UK and the EU on arrangements after Brexit. However, the MPC may also consider renewing a programme of quantitative easing; the prospect of further purchases of gilts in this way has already resulted in 10 year gilt yields falling below 1% for the first time ever. Bank Rate is not anticipated to start rising until quarter 2 2018 and for further increases then to be at a slower pace than before.

3.8 Mark Carney, has repeatedly stated that increases in Bank Rate will be slow and gradual after they do start. The MPC is concerned about the impact of increases on many heavily indebted consumers, especially when the growth in average disposable income is still weak and for some consumers, who have had no increases in pay, could be non-existent (other than through some falls in prices).

Appendix D

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

1.1 The 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 investments (paragraph 1.5 below)
- Compliance with the Treasury Management Code of Practice (paragraph 1.6 below)
- Interest on investments (paragraph 1.7 below)
- Capital Financing Requirement and Minimum Revenue Provision (paragraph 1.8 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 2015/16

	Capital Financing Requirement	**2015/16 Estimate**	**2015/16 Actual**
		£m	**£m**
	Capital Financing Requirement at 1 April 2015	**361**	**361**
add	Financing of new assets	7	-
less	Provision for repayment of debt	(16)	(14)
less	Long term capital loan*	-	(3)
	Capital Financing Requirement at 31 March 2016	**352**	**344**
add	Short Term Borrowing	10	10
	Operational Boundary	**362**	**354**
add	Short Term Borrowing	20	20
	Authorised Limit	**382**	**374**

	Actual Borrowing	**2015/16 Actual**
		£m
	Long Term Borrowing at 1 April 2015	**259**
less	Loan redemptions	(4)
add	New Borrowing	20
	Long Term Borrowing at 31 March 2016	**275**

*The capital loan relates to an outstanding loan with other local authority.

The Capital Financing Requirement includes PFI Schemes and Finance Leases.

The actual Authorised Limit for 2015/16 of £374m 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 Council's 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 with additional amount for a short term borrowing 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 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 2016 of £275m is under the Operational boundary and Authorised limit set for 2015/16. The Operational boundary and Authorised limit have not been exceeded during the year.

1.3 **Interest rate exposure**

The Council continued the practice of seeking to secure competitive fixed interest rate exposure for 2015/16. There are three debt related treasury activity limits. The purpose of these are to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates. However, if these are set to be too restrictive they will impair the opportunities to reduce costs or improve performance. The indicators are:

- Upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates based upon the debt position net of investments;
- Upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates;
- Maturity structure of borrowing. These gross limits are set to reduce the council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

	2015/16	**2016/17**	**2017/18**
Interest rate exposure	**Upper**	**Upper**	**Upper**
Limits on fixed interest rates based on net debt	100%	100%	100%
Limits on variable interest rates based on net debt	15%	15%	15%
Maturity structure of fixed interest rate borrowing 2015/16			
	Lower	**Upper**	**Actual 2015/16**
Under 12 months	0%	25%	2%
12 months and within 24 months	0%	40%	2%
24 months and within 5 years	0%	60%	4%
5 years and within 10 years	0%	80%	9%
10 years and within 20 years	0%	80%	24%
20 years and within 30 years	0%	80%	13%
30 years and within 40 years	0%	80%	34%
40 years and above	0%	80%	13%

The Council has not exceeded the limits set in 2015/16. 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.

1.4 **Interest rate on long term borrowing**

The rate of interest taken on any new long term borrowing has been defined with the assistance of Capita Asset Services (CAS). The Accounts and Pensions Team have set up a recording process to monitor set trigger rates and work to an agreed protocol for potential future borrowing activity to fund the capital programme.

1.5 **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 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 2014/15.

1.6 **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.*

1.7 **Interest on investments**

1.7.1. 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	165	0.66%	0.16%
May	169	0.66%	0.16%
June	168	0.67%	0.17%
July	180	0.68%	0.18%
August	186	0.69%	0.19%
September	181	0.71%	0.21%
October	188	0.73%	0.23%
November	190	0.78%	0.28%
December	190	0.78%	0.28%
January	181	0.78%	0.28%
February	179	0.77%	0.27%
March	187	0.76%	0.26%
Total for 2015/16	**2,164**	**0.73%**	**0.22%**

1.7.2. The total amount received in short term interest for the year was £2.2m at an average rate of 0.73%. 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.

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

1.8.1. 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 2014/15 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.

1.8.2. 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.

1.8.3. 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.

1.8.4 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).

1.8.5. The Council's 2015/16 MRP Policy (as required by CLG Guidance) was approved as part of the Treasury Management Strategy Report for 2015/16 on 28 January 2015.

1.8.6. 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.

	2015/16 Actual	**2016/17 Estimate**	**2017/18 Estimate**	**2018/19 Estimate**
	£m	**£m**	**£m**	**£m**
Total CFR	**344**	**374**	**380**	**370**
Movement in CFR	(17)	30	6	(10)

MINIMUM REVENUE PROVISION (MRP) POLICY STATEMENT 2016/17 ONWARDS

The statutory requirement for local authorities to charge the Revenue Account each year with a specific sum for debt repayment. A variety of options is provided to councils to determine for the financial year an amount of minimum revenue provision (MRP) that it considers to be prudent. This replaces the previous requirement that the minimum sum should be 4% of the Council's Capital Financing Requirement (CFR).

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 relate. The Council is therefore legally obliged to have regard to CLG 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.

The MRP guidance offers four options under which MRP might be made, with an overriding recommendation that the 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).

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 Policy and Strategy.

The International Financial Reporting Standards (IFRS) involves Private Finance Initiative (PFI) contracts and some leases (being reclassified as finance leases instead of operating leases) coming onto the Council's Balance Sheet as long term liabilities. This accounting treatment impacts on the Capital Financing Requirement with an annual MRP provision being required.

To ensure that this change has no overall financial impact on Local Authorities, the Government has updated their "Statutory MRP Guidance" which allows MRP to be equivalent to the existing lease rental payments and "capital repayment element" of annual payments. The implications of these changes are reflected in the Council's MRP policy for 2016/17.

The policy recommended for adoption from 1 April 2016 retains the key elements of the policy previously approved including provisions regarding PFI, closed landfill, and finance leases. The policy for 2016/17 is therefore as follows:-

For capital expenditure incurred before 1 April 2008 or which in the future will be 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.

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 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, closed landfill, and finance lease 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.

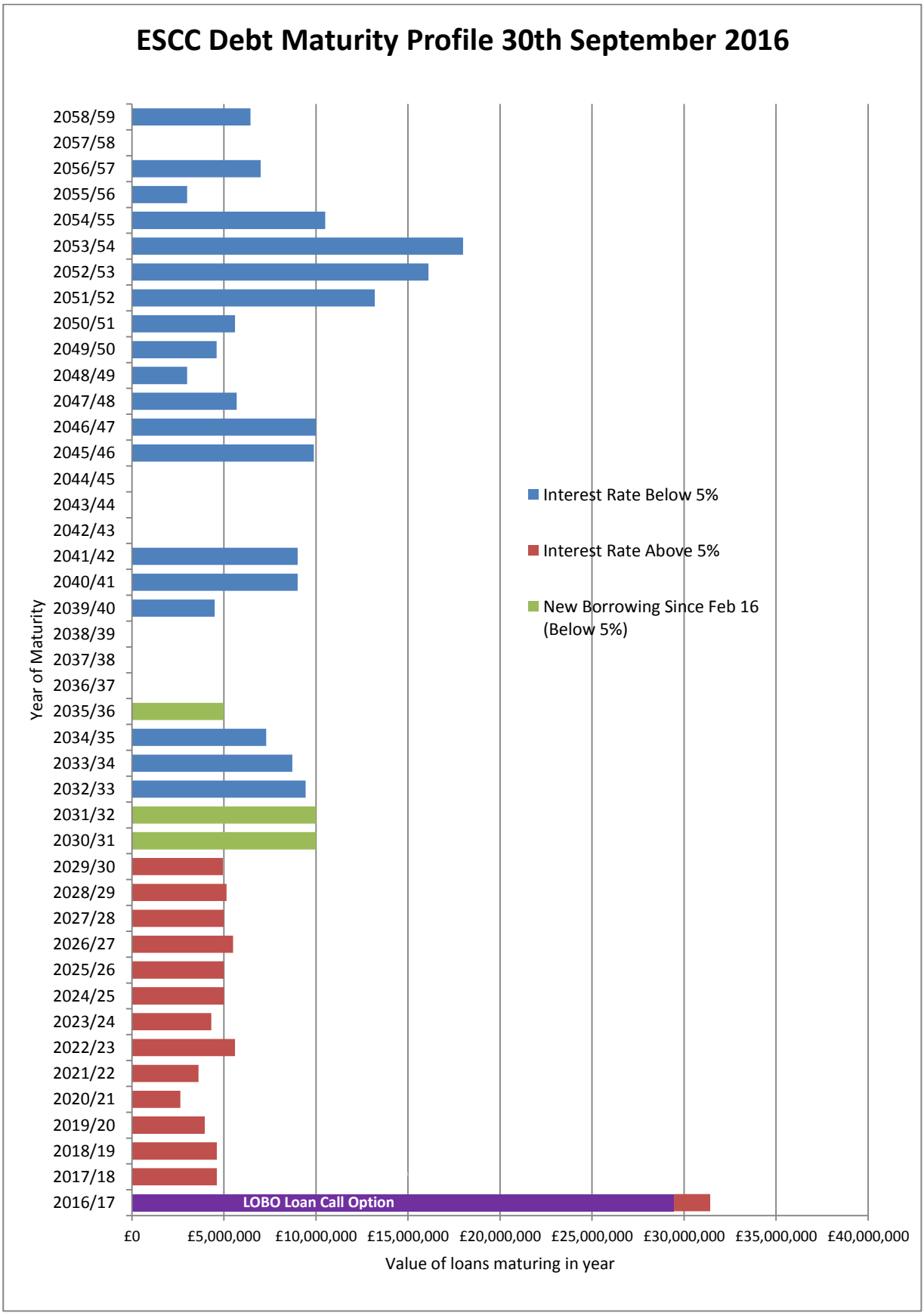
Under both methods, the Council has the option to charge more than the statutory MRP each year through a Voluntary Revenue Provision (VRP).

In view of the variety of different types of capital expenditure incurred by the 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.

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.

A review of the Council's MRP Policy will be undertaken and reported to Members as part of the Treasury Management Strategy report for 2017/18 in February 2017.

Annex 1


ESCC Debt Maturity Profile 30th September 2016
Year of Maturity
2058/59
2057/58
2056/57
2055/56
2054/55
2053/54
2052/53
2051/52
2050/51
2049/50
2048/49
2047/48
2046/47
2045/46
2044/45
2043/44
2042/43
2041/42
2040/41
2039/40
2038/39
2037/38
2036/37
2035/36
2034/35
2033/34
2032/33
2031/32
2030/31
2029/30
2028/29
2027/28
2026/27
2025/26
2024/25
2023/24
2022/23
2021/22
2020/21
2019/20
2018/19
2017/18
2016/17
LOBO Loan Call Option
Interest Rate Below 5%
Interest Rate Above 5%
New Borrowing Since Feb 16 (Below 5%)
£0
£5,000,000
£10,000,000
£15,000,000
£20,000,000
£25,000,000
£30,000,000
£35,000,000
£40,000,000
Value of loans maturing in year