Report to:	**Cabinet**
Date:	**12 December 2017**
By:	**Chief Operating Officer**
Title of report:	**Treasury Management – Stewardship Report 2016/17**
Purpose of report:	**To present a review of the Council's performance on treasury management for the year 2016/17 and Mid Year review for 2017/18, and no changes to the Treasury Management Policy and Strategy are recommended.**

RECOMMENDATION: The Cabinet is recommended to note the Treasury Management performance in 2016/17 incorporating the Mid Year review for the first half of 2017/18.

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 2016/17 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 2017/18 (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 2016/17

3.1 The strategy and the economic conditions prevailing in 2016/17 are set out in Appendix A which is attached to this report. 2016/17 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 2016/17, agreed in January 2016, continued the prudent approach and ensured that all investments were only to the highest quality rated institutions. For banks the maximum investment period was one year and for other local authority lending two years.

<u>Short term lending</u>

4.2 At the Monetary Policy Committee (MPC) meeting 2 November 2017, the MPC by vote of 7-2 increased the Bank of England base rate from 0.25% to 0.50%.

4.3 The total amount received in short term interest for 2016/17 was £1.7m at an average rate of 0.62%. This was above the average base rates in the same period (0.34%) 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

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

- Total of £5m borrowed during 2016/17 from the Public Works Loan Board (PWLB) for a 20 year fixed maturity period at a rate of 2.71%.
- The average interest rate of all debt at 31 March 2017 (£275.4m) was 4.90%.
- 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.
- During 2016/17 Barclays exercised their right to withdrawal their option to change the rate of our LOBO product over the life of the loan. The loan became a fixed rate loan at the same rate of 4.25% and removes future interest rate uncertainty, the £6.45m loan matures in 2058/59.

Minimum Revenue Provision (MRP)

4.5 During 2016/17 a review was undertaken of the councils minimum revenue provision, full details are in appendix D.

5. Treasury Management Mid Year Review 2017/18

5.1 The Treasury Management and Annual Investment Strategy for 2017/18 were approved by the Cabinet on 25 January 2017, the average rate of return for investments to 30 September 2017 was 0.47%.

5.2 No further PWLB borrowing was undertaken and no cost effective opportunities to restructure or repay debt have arisen, although the situation in the markets is closely monitored. During 2017/18 debt to be repaid to the PWLB totals £4.6m, this historic debt is at an average rate of 8%.

5.3 The Minimum Revenue Provision (MRP) was reviewed during 2016/17 and has been adopted for 2017/18.

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 period covered achieved returns between 0.46% and 0.76%. The key principles of security, liquidity and yield are still relevant in the current financial climate, the authority will be looking at future options to improve return within an acceptable level of risk. 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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Chief Operating Officer

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BACKGROUND DOCUMENTS

Cabinet 26 January 2016 Treasury Management Strategy for 2016/17
24 January 2017 Treasury Management Strategy for 2017/18

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 2016/17 and the economic factors affecting this strategy

1. Background information

1.1 Cabinet receive an annual Treasury Management Strategy report in January 2016, 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 2016/17 was drawn up in January 2016, the money markets were still concerned about domestic and 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 2016/17.

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 2016, it emphasised the continued importance of taking account of the current and predicted future state of the financial sector. The Treasury Management advisors (Link 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.

2.2 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.

2.3 This Council in addition to other tools uses the creditworthiness service provided by Link 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 Link 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 Link 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 Link 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 Link Asset Services methodology was revised in October 2015 and determines the maximum investment duration under the credit rating criteria. Key features of Link 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 Link 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 Link 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 investment 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 (TD)	unlimited	1 yr
Government Treasury bills	UK	TD	unlimited	1 yr
Local Authorities	UK	TD	unlimited	1 yr
Lloyds Banking Group • *Lloyds Bank* • *Bank of Scotland*	UK	TD (including callable deposits), Certificate of Deposits (CD's)	£60m	1 yr
RBS/NatWest Group • *Royal Bank of Scotland* • *NatWest*	UK		£60m	1 yr
HSBC	UK		£60m	1 yr
Barclays	UK		£60m	1 yr
Santander	UK		£60m	1 yr
Goldman Sachs Investment Bank	UK		£60m	1 yr
Standard Chartered Bank	UK		£60m	1 yr
Individual Money Market Funds (MMF)	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 AA+				
Australia & New Zealand Banking Group	Australia	TD / CD's	£60m	1 yr
Commonwealth Bank of Australia	Australia	TD / CD's	£60m	1 yr
National Australia Bank	Australia	TD / CD's	£60m	1 yr
Westpac Banking Corporation	Australia	TD / CD's	£60m	1 yr
Royal Bank of Canada	Canada	TD / CD's	£60m	1 yr
Toronto Dominion	Canada	TD / CD's	£60m	1 yr
Development Bank of Singapore	Singapore	TD / CD's	£60m	1 yr
Overseas Chinese Banking Corp	Singapore	TD / CD's	£60m	1 yr

Counterparty	Country/ Domicile	Instrument	Maximum investments	Max. maturity period
United Overseas Bank	Singapore	TD / CD's	£60m	1 yr
Svenska Handelsbanken	Sweden	TD / CD's	£60m	1 yr
Nordea Bank AB	Sweden	TD / CD's	£60m	1 yr
ABN Amro Bank	Netherlands	TD / CD's	£60m	1 yr
Rabobank	Netherlands	TD / CD's	£60m	1 yr
ING Bank NV	Netherlands	TD / CD's	£60m	1 yr
Deutsche Bank	Germany	TD / CD's	£60m	1 yr
DZ Bank	Germany	TD / CD's	£60m	1 yr
UBS	Switzerland	TD / CD's	£60m	1 yr
Credit Suisse	Switzerland	TD / CD's	£60m	1 yr
Danske Bank	Denmark	TD / CD's	£60m	1 yr
* Nordea Bank	Finland	TD / CD's	£60m	1 yr
* Pohjola Bank	Finland	TD / CD's	£60m	1 yr
* JP Morgan Chase	U.S.A	TD / CD's	£60m	1 yr

* Note – a change per the 2016/17 strategy.

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 2016/17 – Commentary from Link Asset Services (Treasury Management Advisors) in April 2017.

4.1 The two major landmark events that had a significant influence on financial markets in the 2016-17 financial year were the UK EU referendum on 23 June and the election of President Trump in the USA on 9 November. The first event had an immediate impact in terms of market expectations of when the first increase in Bank Rate would happen, pushing it back from quarter 3 2018 to quarter 4 2019. At its 4 August meeting, the Monetary Policy Committee (MPC) cut Bank Rate from 0.5% to 0.25% and the Bank of England's Inflation Report produced forecasts warning of a major shock to economic activity in the UK, which would cause economic growth to fall almost to zero in the second half of 2016. The MPC also warned that it would be considering cutting Bank Rate again towards the end of 2016 in order to support growth. In addition, it restarted quantitative easing with purchases of £60bn of gilts and £10bn of corporate bonds, and also introduced the Term Funding Scheme whereby potentially £100bn of cheap financing was made available to banks.

4.2 In the second half of 2016, the UK economy confounded the Bank's pessimistic forecasts of August. After a disappointing quarter 1 of only +0.2% GDP growth, the three subsequent quarters of 2016 came in at +0.6%, +0.5% and +0.7% to produce an annual growth for 2016 overall, compared to 2015, of no less than 1.8%, which was very nearly the fastest rate of growth of any of the G7 countries. Needless to say, this meant that the MPC did not cut Bank Rate again after August but, since then, inflation has risen rapidly due to the effects of the sharp devaluation of sterling after the referendum. By the end of March 2017, sterling was 17% down against the dollar but had not fallen as far against the euro. In February 2017, the latest CPI inflation figure had risen to 2.3%, above the MPC's inflation target of 2%.

4.3 However, the MPC's view was that it would look through near term supply side driven inflation, (i.e. not raise Bank Rate), caused by sterling's devaluation, despite forecasting that inflation would reach nearly 3% during 2017 and 2018. This outlook, however, is dependent on domestically generated inflation, (i.e. wage inflation), continuing to remain subdued despite the fact that unemployment is at historically very low levels and is on a downward trend. Market expectations for the first increase in Bank Rate moved forward to quarter 3 2018 by the end of March 2017 in response to increasing concerns around inflation.

Appendix B

The Treasury Management activity during the year 2016/17

1. Short term lending interest rates

1.1 Base interest rate was lowered in August 2016 to 0.25%. The average rate for the year was 0.34%.

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 2016/17, agreed in January 2016, continued the prudent approach and ensured that all investments were only to the highest quality rated banks using Link's colour coded credit methodology.

1.4 The total amount received in short term interest for 2016/17 was £1.7m at an average rate of 0.62%. This was above the average of base rates in the same period (0.34%) 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

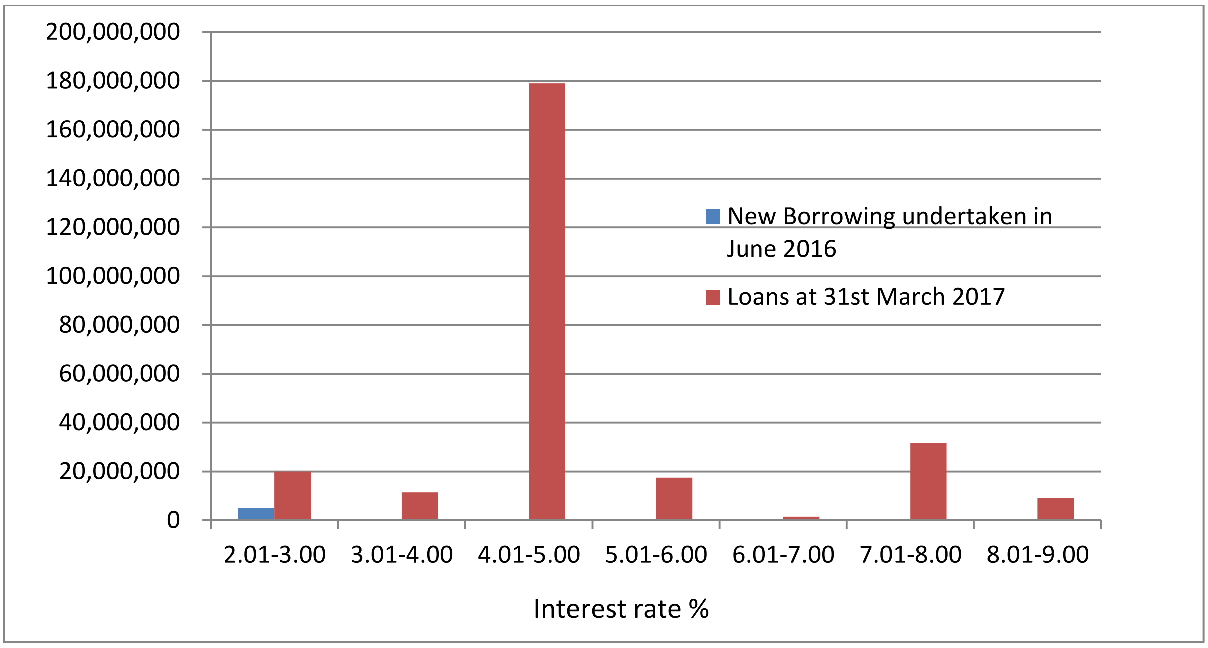
2.1 The Council's strategy was to maintain external borrowing below the level of the CFR – known as internal borrowing. However in the financial climate of low interest rates Officers constantly reviewed the need to borrow taking into consideration the potential increases in borrrowing costs, the need 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 June 2016 the Council took advantage of attractive PWLB rates and borrowed £5m in order to generate cash for the future Capital programme. This fixed term borrowing was in the 20 year maturity period the rate taken was 2.71%.

2.3 The average interest rate of all debt at 31 March 2017 of £275.4m was 4.90%. 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 2016/17 to date to cover temporary overdraft situations.

4 Treasury Management Advisers

4.1 The Strategy for 2016/17 explained that the Council uses Link 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 Link 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 - 2017/18

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 2017/18 were approved by the Cabinet 24 January 2017 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 During the first half year investments have been held in bank notice accounts, cash money market funds and other local authorities. Counterparty credit quality remains a primary concern for the treasury team, with security, liquidity and yield in that order a priority. Measures have been taken to reduce the level of liquidity (prudently) to improve returns, the impact of this will take effect in the next 6 months. The average investment balance to September 2017 was £262m generated investments income of £622k. The forecast for 2016/17 is £1.4m, dependant on potential bank rate increases.

1.4 The level of Council debt at 30 September 2017 was £274.1m with two loans totalling £3.3m maturing with the PWLB on 31 December 2017. The forecast for interest paid on long-term debt in 2017/18 is approximately £13.15m and is within the budgeted provision.

2. Treasury Management Strategy

2.1 The Council approved the 2017/18 treasury management strategy at its meeting on 24 January 2017. 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 have been monitored closely. No further external borrowing has been undertaken in the period. 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 2017 to September 2017 period broadly complied with the approved strategy, the CIPFA Code of Practice, and the relevant legislative provisions.

3. Economic Review

3.1 The Monetary Policy Committee (MPC) meeting of 2 November 2017 came up with two major developments: -

- After the MPC painted themselves into a corner with their words following their previous meeting on 14 September, it was a virtual certainty that Bank Rate would go up by 0.25% this time around. The MPC duly delivered on those words by a vote of 7-2 to remove the post EU referendum emergency monetary stimulus implemented in August 2016 by reversing the cut in Bank Rate at that time from 0.5% to 0.25%.

- The MPC also gave forward guidance that they expected to increase Bank Rate only twice more in the next three years to reach 1.0% by 2020. This is, therefore, not quite the ‘one and done’ scenario but is, nevertheless, a very relaxed rate of increase prediction in Bank Rate in line with previous statements that Bank Rate would only go up very gradually and to a limited extent.

3.2 The markets viewed this result as being more dovish than they had expected and sterling duly responded by falling 0.8% against the dollar and euro on the day. As this was the first increase in Bank Rate for a decade, the MPC was right to avoid alarming consumers and financial markets, and to be very reassuring about the pace of future increases. The quarterly Inflation Report itself, was notably downbeat about economic growth based on a view that the trend rate of growth for the economy has now fallen from 2.2% to only 1.5%, (whereas in the decade before the financial crash it grew at 2.9% p.a.).

3.3 It has to be said that overall, this is really a quite pessimistic outlook for the UK economy. For some commentators, raising Bank Rate with such a weak outlook, did not sit easily together. However, the MPC's main justification for taking action now to raise Bank Rate was that because unemployment was at the lowest rate for 42 years at only 4.3%, there was little spare capacity left in the economy, especially when increases in productivity were expected to be so weak and taking account of Brexit caused expected falls in net immigration.

3.4 They also noted that consumer confidence has remained resilient and the global economy was growing strongly which would help UK exports. In addition, financial conditions were highly accommodative through the current level of monetary policy.

Link Asset Services (LAS) forecasts

3.5 The MPC made some obvious comments around the fact that the UK is going through a period of heightened uncertainty due, particularly, to the unknowns around how the Brexit negotiations will proceed and the likely effect on households and companies. They will adjust their responses according to how these turn out and in the light of how the economy progresses over the next two to three years.

3.6 LAS own forecasts are cautious and in line with this subdued path for increases in Bank Rate; and do not currently see inflation posing a significant threat over the next three years. LAS have 0.25% increases in November 2018 to 0.75%, 1.0% in November 2019 and 1.25% in August 2020. This is much in line with market expectations. LAS central assumption is that the UK will make progress with concluding a satisfactory outcome over the Brexit negotiations with the EU by March 2019, although the UK finance sector is likely to be an area of particular concern and difficulty.

Interest Rate Forecast

3.7 Economic forecasting remains difficult with so many external influences weighing on the UK. LAS Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring relatively more “risky” assets i.e. equities, or the “safe haven” of government bonds. LAS is of the view that previous interest rate revision newsflashes of just how unpredictable PWLB rates and bond yields are at present, and the revised forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012.

3.8 As there are so many variables at this time, caution must be exercised in respect of all interest rate forecasts. The general expectation for an eventual trend of gently rising gilt yields and PWLB rates is expected to remain unchanged. Negative, (or positive), developments could significantly impact safe-haven flows of investor money into UK, US and German bonds and produce shorter term movements away from central forecasts. Naturally, we will continue to monitor events and will update our forecasts as and when appropriate.

3.9 The Council's treasury advisor, Link Asset Services (LAS), has provided the following forecast:

	NOW	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
BANK RATE	0.50	0.50	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.25	1.25	1.25
3 month LIBID	0.40	0.40	0.40	0.40	0.40	0.60	0.60	0.60	0.70	0.90	0.90	1.00	1.20	1.20	1.20
6 month LIBID	0.45	0.50	0.50	0.50	0.60	0.80	0.80	0.80	0.90	1.00	1.00	1.10	1.30	1.30	1.40
12 month LIBID	0.65	0.70	0.80	0.80	0.90	1.00	1.00	1.10	1.10	1.30	1.30	1.40	1.50	1.50	1.60
5 yr PWLB	1.50	1.50	1.60	1.60	1.70	1.80	1.80	1.90	1.90	2.00	2.10	2.10	2.20	2.30	2.30
10 yr PWLB	2.10	2.10	2.20	2.30	2.40	2.40	2.50	2.60	2.60	2.70	2.70	2.80	2.90	2.90	3.00
25 yr PWLB	2.70	2.80	2.90	3.00	3.00	3.10	3.10	3.20	3.20	3.30	3.40	3.50	3.50	3.60	3.60
50 yr PWLB	2.40	2.50	2.60	2.70	2.80	2.90	2.90	3.00	3.00	3.10	3.20	3.30	3.30	3.40	3.40

Borrowing advice:

3.10 Although yields have risen from their low points, yields are still around historic lows and borrowing should be considered if appropriate to Council's strategy. LAS still see value in the 40yr to 50yr range at present but that view would be negated if Bank Rate does not climb to at least 2.5% over the coming years. Accordingly, Council's will need to review and assess their risk appetite in terms of any underlying borrowing requirement they may have, and also project forward their position in respect of cash backed resources. Any new borrowing should also take into account the continuing cost of carry, the difference between investment earnings and borrowing rates, especially as LAS forecasts indicate that Bank Rate may rise to only 1.25% by March 2021.

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 2016/17

	Capital Financing Requirement	**2016/17 Estimate**	**2016/17 Actual**
		£m	**£m**
	Capital Financing Requirement at 1 April 2016	**352**	**344**
add	Financing of new assets	55	2
less	Provision for repayment of debt	(15)	(11)
less	Long term Capital loan*	-	-
	Capital Financing Requirement at 31 March 2017	**392**	**335**
add	Short Term Borrowing Provision	10	
	Operational Boundary	**402**	
add	Short Term Borrowing Provision	20	
	Authorised Limit	**422**	

	Actual Borrowing	**2016/17 Actual**
		£m
	Long Term Borrowing at 1 April 2016	**275**
less	Loan redemptions	(4)
add	New Borrowing	5
	Long Term Borrowing at 31 March 2017	**276**

*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 2016/17 of £422m 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 2017 of £275.4m is under the Operational boundary and Authorised limit set for 2016/17. 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.

	2016/17	**2017/18**	**2018/19**
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 2016/17			
	Lower	**Upper**	**Actual 2016/17**
Under 12 months	0%	25%	1%
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%	16%
30 years and within 40 years	0%	80%	33%
40 years and above	0%	80%	11%

The Council has not exceeded the limits set in 2016/17. 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 Link Asset Services (LAS). 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 since 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	174	0.77%	0.27%
May	181	0.75%	0.25%
June	176	0.74%	0.24%
July	185	0.74%	0.24%
August	160	0.64%	0.39%
September	133	0.56%	0.31%
October	130	0.55%	0.30%
November	123	0.55%	0.30%
December	121	0.55%	0.30%
January	120	0.54%	0.29%
February	104	0.47%	0.22%
March	108	0.50%	0.25%
Total for 2016/17	**1,715**	**0.62%**	**0.28%**

1.7.2. The total amount received in short term interest for the year was £1.7m at an average rate of 0.62%. This was above the average of base rates in the same period (0.34%) 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 2016/17 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 2016/17 MRP Policy (as required by CLG Guidance) was approved as part of the Treasury Management Strategy Report for 2016/17 on 26 January 2016.

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.

	2016/17 Actual	**2017/18 Estimate**	**2018/19 Estimate**	**2018/19 Estimate**
	£m	**£m**	**£m**	**£m**
Total CFR	**335**	**366**	**369**	**369**
Movement in CFR	(9)	31	3	-

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 from 2016/17.

The *revised* policy recommended for adoption from 1 April 2016 and 1 April 2017 retains the key elements of the policy previously approved including provisions regarding PFI, closed landfill, and finance leases. The ongoing policy from 2016/17 and future years is therefore as follows:-

For borrowing incurred before 1 April 2008, the MRP policy will be:

- Straight line basis over the next 45 years to coincide with the repayment of external debt.

From borrowing incurred after 1 April 2008, the MRP policy will be:

- Asset Life Method (equal instalment method) – MRP will be based on the estimated life of the assets, in accordance with the proposed regulations. This option will also be applied for any expenditure Capitalised under a Capitalisation directive.

For PFI schemes, finance leases and closed landfill sites that come onto the Balance Sheet, the MRP policy will be:

- Asset Life Method (annuity method) - The MRP will be calculated according to the flow of benefits from the asset, and where the principal repayments increase over the life of the asset. Any related MRP will be equivalent to the "Capital repayment element" of the annual charge payable.

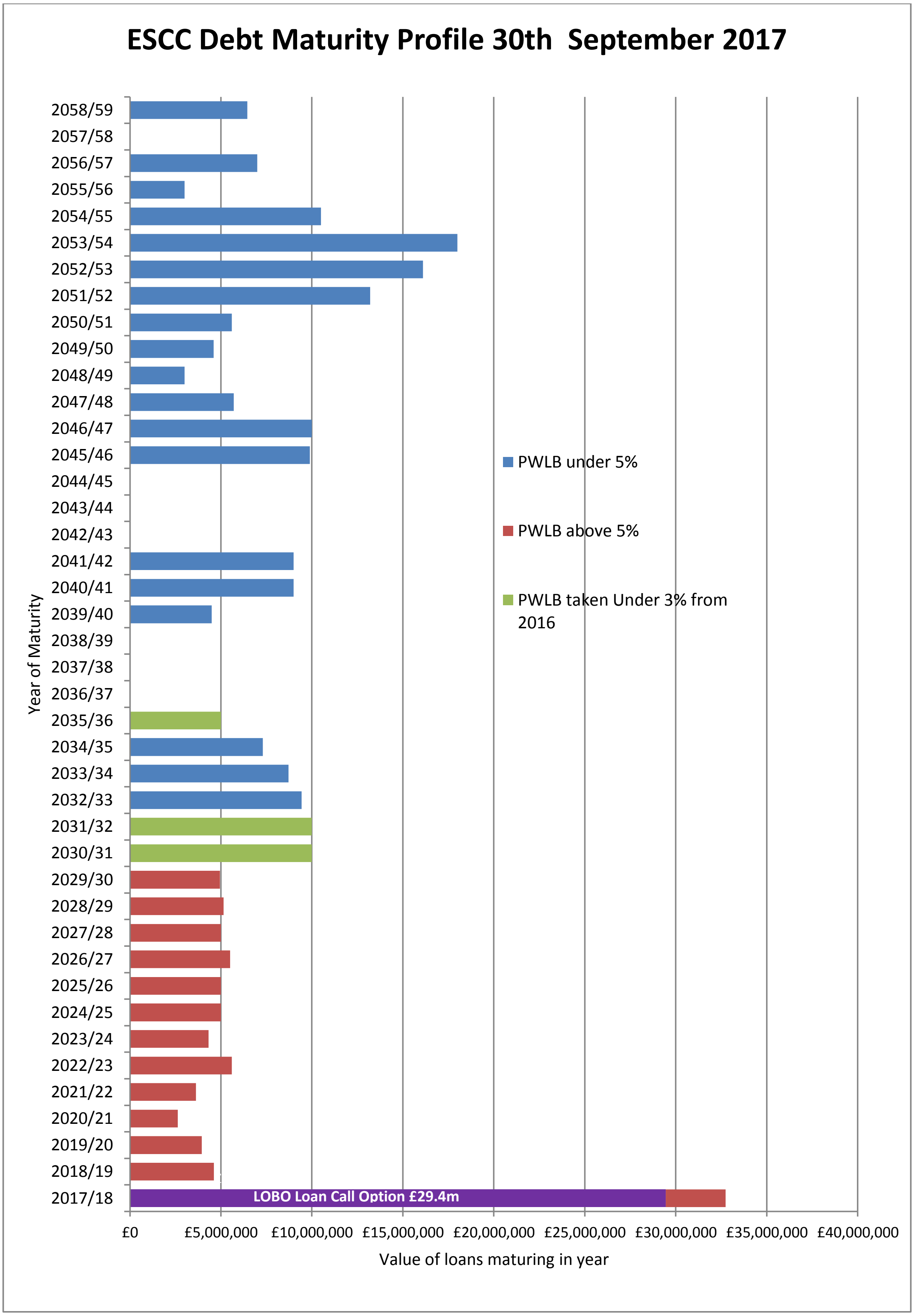
There is the option to charge more than the prudent provision of MRP each year through a Voluntary Revenue Provision (VRP).

For loans to third parties that are being used to fund expenditure that is classed as Capital in nature, the policy will be to set aside the repayments of principal as Capital receipts to finance the initial Capital advance in lieu of making an MRP.

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.

Annex 1


ESCC Debt Maturity Profile 30th September 2017
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
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2041/42
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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
Year of Maturity
LOBO Loan Call Option £29.4m
PWLB under 5%
PWLB above 5%
PWLB taken Under 3% from 2016
£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