Report to:	**Cabinet**
Date:	**13 October 2015**
By:	**Chief Operating Officer**
Title of report:	**Treasury Management – Stewardship Report 2014/15 and Half Year Review 2015/16**
Purpose of report:	**To present a review of the County Council's performance on treasury management for the year 2014/15 and Mid Year review for 2015/16.**

RECOMMENDATION: The Cabinet is recommended to note the Treasury Management performance in 2014/15 incorporating the Mid Year review for the first half of 2015/16

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1. Introduction

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

2. Supporting Information

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

- Forecast the likely activity for the forthcoming year (in the Annual Treasury Strategy Report);
- Review actual activity for the preceding year (this Stewardship report); and
- A mid year review.

2.2 This report sets out:

- A summary of the original strategy agreed for 2014/15 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 2015/16 (Appendix C);
- The Prudential Indicators, which relate to the Treasury function and compliance with limits (Appendix D).

3. The economic conditions compared to our Strategy for 2014/15

3.1 The strategy and the economic conditions prevailing in 2014/15 are set out in Appendix A which is attached to this report. 2014/15 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 2014/15, agreed in January 2014, 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 2014/15 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 2014/15 was £2.20m at an average rate of 0.62%. 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.

Short term borrowing

4.3 No borrowing was undertaken on a short-term basis during 2014/15 to cover temporary overdraft situations.

Long term borrowing

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

- No new borrowing was undertaking during 2014/15. It was agreed to use “internal borrowing” to finance new capital investment
- The average interest rate of all debt at 31 March 2015 (£259m) was 5.20%.
- Although a proactive approach has been taken to repayment and restructuring of debt, no cost effective opportunities arose during the year.

5. Treasury Management Mid Year Review 2015/16

5.1 The Treasury Management and Annual Investment Strategy for 2015/16 were approved by the Cabinet 27 January 2015, the average rate of return for investments to August 2015 was 0.67%.

6. Local Capital Finance Company Limited

6.1 The Local Government Association (LGA) has created a Local Capital Finance Company Limited (previously know as Municipal Bonds Agency) which it believes will allow councils to raise funds at significantly lower rates than those offered by the PWLB. The Cabinet at its 29 June 2015 meeting recommend the County Council agree the amendments to the Treasury Management Strategy to facilitate investment in a wholly local government owned company.

7. Lender Option Borrower Option (LOBO) Loans

7.1 The Council has £35.9m of LOBO loans where the lender has the option to propose a change to the interest rate at set dates, following which the Council has the option to either accept a new rate or to repay the loan at no additional cost. In the current interest rate climate it is unlikely that lenders will exercise their options, and the Council will take the option to repay any LOBO loan at no cost if it has the opportunity to do so. A summary of findings as a result of the review undertaken by Officers in conjunction with the Council’s Treasury Advisors (Capita) are set out in Appendix C

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

8.1 The County Council is required by the CIPFA Prudential Code to report the actual prudential indicators after the end of each year. There are eight indicators which relate to treasury management and they are set out in Appendix D.

9. Conclusion and reason for recommendation

9.1 This report updates the Committee and fulfils the requirement to submit an annual/half yearly report in the form prescribed in the Treasury Management Code of Practice. Short term lending throughout the year saw returns increase steadily from 0.57% to 0.66%. This reflects the objective to ensure so far as possible in the financial climate, a prudent approach with security and liquidity as the main criteria before yield. Exposure to future risk continues to be minimised through proactive and constant review of the treasury management policy. The emphasis must continue to be able to pre-empt/react quickly if market conditions worsen.

KEVIN FOSTER

Chief Operating Officer

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BACKGROUND DOCUMENTS

Cabinet 28 January 2014 Treasury Management Strategy for 2014/15
27 January 2015 Treasury Management Strategy for 2015/16

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 2014/15 and the economic factors affecting this strategy

1. Background information

1.1 Cabinet receive an annual Treasury Management Strategy report in January 2014, which sets out the proposed strategy for the year ahead. This strategy includes the limits and criteria for organisations to be used for the investment of cash surpluses and has to be approved by the County Council.

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

1.3 When the original strategy for 2014/15 was drawn up in January 2014, 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 2014/15.

East Sussex County Council defined its treasury management activities as:

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

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

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

2. Long term borrowing

2.1 County Council's past strategy was to borrow to support the Capital Programme and lend out other cash (rather than using internal borrowing). Historically this meant that the interest rate earned on cash balances was higher than the interest rate paid on loans from the Public Works Loans Board (PWLB). In the current financial climate, this interest rate differential has been removed. No new PWLB borrowing has taken place since January 2008. The average rate of all debt at 31 March 2015 of £259m is 5.20% (2013/14 of £262.9m is 5.20%). No new loans have been taken and no beneficial rescheduling of debt has been available

2.2 Our opportunity to restructure our debt has been significantly reduced since October 2010 as a result of the PWLB increasing all of its lending rates by 1% as part of the Government's Comprehensive Spending Review. However, it did not increase the rate of interest used for repaying debt so that not only the cost of our future borrowing has increased but our opportunity to restructure our debt when market conditions allow has been significantly reduced.

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

3. Investment

3.1 When the strategy was agreed in January 2014, 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.

3.2 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.

3.3 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.

3.4 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 County Councils cash balances.

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

3.6 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.

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

3.8 No new external borrowing was undertaken in 2014/15.

3.9 Opportunities for cost effective repayment of existing debt and restructuring opportunities would be constantly monitored and would have been taken if and when they emerged.

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

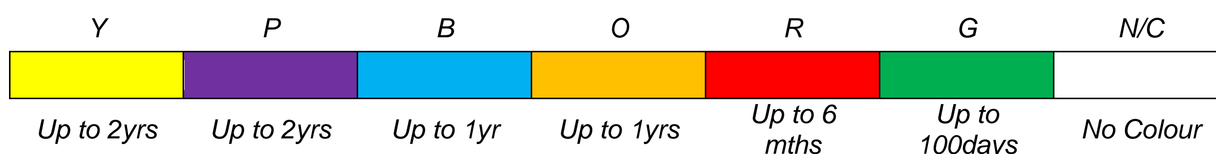
3.11 Investment instruments identified for use in the financial year are listed in section 4.2 and 4.4 under the 'Specified and Non-Specified' Investments categories. Counterparty limits will be as set through the Council's Treasury Management Practices – Schedules.

3.12 The Councils balances were to be invested in line with the following specific methodology:-

The modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative credit worthiness of counterparties. These colour codes are used by the Authority to determine the duration for investments. The strategy provides scope to invest in AAA rated foreign banks.

However the Authority proposes to only use counterparties (Appendix 6) within the following durational bands that are domiciled in the UK.

- 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



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 2014 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.

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

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

4. Specified Investments

4.1 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.

4.2 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:

<table>
<tr><th>Counterparty</th><th>Country/Domicile</th><th>Instrument</th><th>Maximum investments</th><th>Max. maturity period</th></tr>
<tr><td>Debt Management and Depost Facilities (DMADF)</td><td>UK</td><td>Term Deposits</td><td>unlimited</td><td>12 months</td></tr>
<tr><td>Government Treasury blls</td><td>UK</td><td>Term Deposits</td><td>unlimited</td><td>12 months</td></tr>
<tr><td>Local Authorities</td><td>UK</td><td>Term Deposits</td><td>unlimited</td><td>12 months</td></tr>
<tr><td>RBS/NatWest Group
• Royal Bank of Scotland
• NatWest</td><td>UK</td><td rowspan="2">Term Deposits (including callable deposits), Certificate of Deposits</td><td>£60m</td><td>1 yr</td></tr>
<tr><td>Lloyds Banking Group
• Lloyds Bank
• Bank of Scotland</td><td>UK</td><td>£60m</td><td>1 yr</td></tr>
</table>

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

4.3 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

4.4 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

4.5 The council had no exposure in Non-Specified investments during the 2014/15.

5. The economy in 2014/15 – Commentary from Capita Asset Services (Treasury Management Advisors) in May 2015.

5.1 The original market expectation at the beginning of 2014/15 was for the first increase in Bank Rate to occur in quarter 1 2015 as the unemployment rate had fallen much faster than expected through the Bank of England's initial forward guidance target of 7%. In May, however, the Bank revised its forward guidance. A combination of very weak pay rises and inflation above the rate of pay rises meant that consumer disposable income was still being eroded and in August the Bank halved its forecast for pay inflation in 2014 from 2.5% to 1.25%. Expectations for the first increase in Bank Rate therefore started to recede as growth was still heavily dependent on buoyant consumer demand.

5.2 During the second half of 2014 financial markets were caught out by a halving of the oil price and the collapse of the peg between the Swiss franc and the euro. Fears also increased considerably that the European Central Bank (ECB) was going to do too little too late to ward off the threat of deflation and recession in the Eurozone (EZ). In mid-October, financial markets had a major panic for about a week. By the end of 2014, it was clear that inflation in the UK was going to head towards zero in 2015 and possibly even turns negative. In turn, this made it clear that the Bank of England's Monetary Policy Committee (MPC) would have great difficulty in starting to raise Bank Rate in 2015 while inflation was around zero and so market expectations for the first increase receded back to around quarter 3 of 2016. .

5.3 Gilt yields were on a falling trend for much of the last eight months of 2014/15 but were then pulled in different directions by increasing fears after the anti-austerity parties won power in Greece in January; developments since then have increased fears that Greece could be heading for an exit from the euro. While the direct effects of this would be manageable by the EU and ECB, it is very hard to quantify quite what the potential knock on effects would be on other countries in the Eurozone once the so called impossibility of a country leaving the EZ had been disproved.

5.4 Another downward pressure on gilt yields was the announcement in January that the ECB would start a major programme of quantitative easing, purchasing EZ government and other debt in March. On the other hand, strong growth in the US caused an increase in confidence that the US was well on the way to making a full recovery from the financial crash and would be the first country to start increasing its central rate, probably by the end of 2015. The UK would be closely following it due to strong growth over both 2013 and 2014 and good prospects for a continuation into 2015 and beyond. However, there was also an increase in concerns around political risk from the general election due in May 2015. The UK coalition Government maintained its tight fiscal policy stance but recent strong economic growth and falling gilt yields led to a reduction in the forecasts for total borrowing in the March budget.

5.5 The EU sovereign debt crisis had subsided since 2012 until the Greek election in January 2015 sparked a resurgence of fears. While the UK and its banking system has little direct exposure to Greece, it is much more difficult to quantify quite what effects there would be if contagion from a Greek exit from the euro were to severely impact other major countries in the EZ and cause major damage to their banks.

Appendix B

The treasury management activity during the year

1. Short term lending interest rates

1.1 Base interest rate remained at 0.50% throughout 2014/15. The rate is the lowest ever rate and the rate has remained unchanged for the longest period on record. The last change was over five years ago in March 2009.

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

1.3 The strategy for 2014/15, agreed in January 2014, continued the prudent approach and ensured that all investments were only to the highest quality rated banks and only up to a period of up to two years.

1.4 The total amount received in short term interest for 2014/15 was £2.2m at an average rate of 0.62%. 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. This base rates return improved slightly towards the end of the financial year as a result of implementing a revised strategy approved in January 2014.

2. Long term borrowing

2.1 The County Council has had a strategy to borrow to support the Capital Programme and lend out surplus cash. Historically this meant that the interest rate earned on cash balances was higher than the interest rate paid on loans from the Public Works Loans Board (PWLB). In the current financial climate, this interest rate differential has been removed. The cost of new borrowing is now well in excess of the rate achievable on our investments.

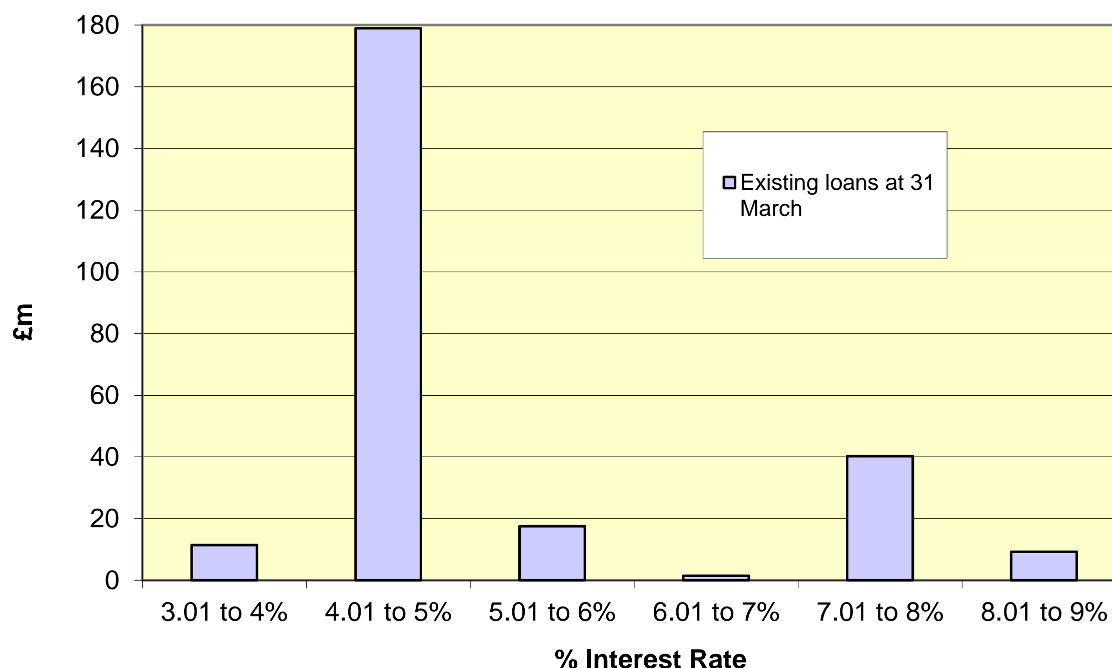
2.2 Given the current low rates of interest available, the Council has given consideration to possible future tranches of borrowing. In the short term this may lead to a 'cost of carry' as the interest rate on debt is higher than the rate at which we are earning interest on investments. However, from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

2.3 The average interest rate of all debt at 31 March 2015 of £259m was 5.20%.

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

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

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



3. Short term borrowing

3.1 No borrowing was undertaken on a short-term basis during 2014/15 to date to cover temporary overdraft situations.

4 Treasury Management Advisers

4.1 The Strategy for 2014/15 explained that the County Council uses Capita as its treasury management consultant on a range of services which include:

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

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

4.2 Capita is the largest provider of Treasury Management advice services to local authorities in the UK and they claim to be the market leading treasury management service provider to their clients. The advice has been and will continue to be monitored regularly to ensure a continued excellent advisory service.

Appendix C

The Treasury Management Activity Mid-Year Report - 2015/16

1. Background

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

1.2 The Treasury Management and Annual Investment Strategy for 2015/16 were approved by the Cabinet 27 January 2015 and there have been no policy changes to date. This report considers treasury management activity over five months of the financial year.

Summary of financial implications

1.3 The level of Council debt at August 2015 is currently £259m with two loans totalling £2.6m maturing with the PWLB in September 2015. The forecast for interest paid on long-term debt in 2015/16 is approximately £13.5m and is within the budgeted provision. The average balance of investments of approximately £305m generated investments income of £896k to August 2015. The forecast for 2015/16 is £2.40m, exceeding the previous year outturn of £2.25m.

2. Treasury Management Strategy

2.1 The Council approved the 2015/16 treasury management strategy at its meeting on 27 January 2015. The Council's stated investment strategy is to prudently manage an investment policy achieving first of all, security (protecting the capital sum from loss), liquidity (keeping money readily available for expenditure when needed), and to consider what yield can be obtained consistent with those priorities.

2.2 The Council's exposure to security and interest rate risk could have been reduced by repaying some of the £259m outstanding long-term debt as at August 2015, and, where possible, by rescheduling the average maturity of the loans. However under the current economic conditions the costs of doing so in terms of interest and premium payable would be prohibitive.

2.3 The Chief Finance Officer is pleased to report that all treasury management activity undertaken from April 2015 to August 2015 period broadly complied with the approved strategy, the CIPFA Code of Practice, and the relevant legislative provisions.

3. Economic Review

3.1 After strong UK GDP growth in 2013 at an annual rate of 2.7% and 3.0% in 2014, quarter 1 of 2015 was disappointing at only 0.4%, though subsequent data indicates that this could well be revised up further down the line and also indicates a return to stronger growth in quarter 2. In its May quarterly Inflation Report, the Bank of England reduced its GDP forecast for 2015 from 2.9% to 2.5% and from 2.9% to 2.7% in 2016, while increasing its forecast for 2017 from 2.4% to 2.7%.

3.2 Uncertainty around the likely result of the UK general election in May has obviously now evaporated although this has been replaced by some uncertainty around the potential impact on the UK economy of the EU referendum promised by, or in, 2017. In addition, the firm commitment of the Conservative Government to eliminating the deficit within the term of this Parliament will have an impact on GDP growth rates. However, the MPC is fully alert to this and will take that into account, and also the potential spill over effects from the Greek crisis, in making its decisions on the timing of raising Bank Rate.

3.3 In the American economy, confidence has improved markedly in this quarter that the US will start increasing the Fed funds rate by the end of 2015 due to a return to strong economic GDP growth after a disappointing start to the year in quarter 1, (a contraction of 0.2%), after achieving 2.4% growth in 2014.

3.4 In the Eurozone, the ECB in January 2015 issued €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it is intended to run initially to September 2016. This already appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to a significant improvement in economic growth, though it remains to be seen whether this will have an enduring effect as strong as the recovery in the US and UK.

Interest Rate Forecast

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

	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank rate	0.50%	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.50%	1.50%	1.75%
5yr PWLB rate	2.30%	2.40%	2.50%	2.60%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%
10yr PWLB rate	2.90%	3.00%	3.20%	3.30%	3.40%	3.50%	3.70%	3.80%	3.90%	4.00%	4.10%
25yr PWLB rate	3.60%	3.70%	3.80%	4.00%	4.10%	4.20%	4.30%	4.40%	4.40%	4.50%	4.60%
50yr PWLB rate	3.60%	3.70%	3.80%	4.00%	4.10%	4.20%	4.30%	4.40%	4.40%	4.50%	4.60%

3.6 Capita Asset Services undertook a review of its interest rate forecasts after the May Bank of England Inflation Report. The ECB's quantitative easing programme to buy up EZ debt caused an initial widespread rise in bond prices and, correspondingly, a fall in bond yields to phenomenally low levels, including the debt of some European countries plunging into negative yields. Since then, fears about recession in the EZ, and around the risks of deflation, have abated and so there has been an unwinding of this initial phase with bond yields rising back to more normal, though still historically low yields.

3.7 This latest forecast includes a move in the timing of the first increase in Bank Rate from quarter 1 of 2016 to quarter 2 of 2016 as a result primarily of poor growth in quarter 1, weak wage inflation and the recent sharp fall in inflation due to the fall in the price of oil and the impact of that on core inflation. The UK fell marginally into deflation in April (-0.1%) and figures near zero will prevail for about the next six months until the major fall in oil prices in the latter part of 2014 falls out of the twelve month calculation of CPI inflation.

3.8 The Governor of the Bank of England, Mark Carney, has repeatedly stated that increases in Bank Rate will be slow and gradual. The MPC is concerned about the impact of increases on many heavily indebted consumers, especially when average disposable income is only just starting a significant recovery as a result of recent increases in the rate of wage inflation, though some consumers will not have seen that benefit come through for them.

4. Amendment to the 2015/16 Treasury Management Strategy - Local Capital Finance Company Limited

4.1 The Local Government Association (LGA) has created a Local Capital Finance Company Limited (formerly known as the Municipal Bonds Agency (MBA)) which it believes will allow councils to raise funds at significantly lower rates than those offered by the PWLB. It is an independent company with the sole aim of reducing financing costs for councils through arranging lending at competitive interest rates. It is envisaged that the company will fund lending through any or all of the following:

- Raising money on the capital markets through issuing bonds
- Arranging lending or borrowing directly from local authorities
- Sourcing funding from other third party sources, such as banks, pension funds or insurance companies.

4.2 The County Council is giving consideration to whether to participate in the scheme and a report will be taken to the Lead Member shortly for decision. The Council is currently in negotiations to determine the level of its participation in the scheme.

4.3 The benefit from the creation of the Local Capital Finance Company Limited includes the opportunity to access European Investment Bank (EIB) funding for future Council infrastructure development. EIB rates are lower than PWLB rates, but cannot usually be accessed by local authorities, because, in most cases, the EIB will only lend money for specific projects worth £250 million or more (in some cases the EIB will help to finance £150 million projects) for which it will provide up to half the funding.

4.4 In order to participate in the scheme, the Cabinet at its 29 June 2015 meeting recommend the County Council agree the amendments to the Treasury Management Strategy to facilitate investment in a wholly local government owned company. The following sentences will be **added** to the Treasury Management Strategy (para 5.17:

'The Council may make an investment in the form of shares in the municipal bonds agency (Local Capital Finance Company Limited) where the primary purpose is to support the Council's priorities rather than to speculate on the capital sum invested. With the exception of the municipal bonds agency investment, only investments where there is no contractual risk to the capital invested and where the rate of return justifies their use will be entered into.

Non-Specified investments are any other type of investment (i.e. not defined as specified above). The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out in Table 4 below. Non specified investments would include the purchase of shares in the municipal bonds agency (Local Capital Finance Company Limited).'

5. Lender Option Borrower Option (LOBO) Loans

5.1 LOBO stands for Lender Option Borrower Option. Long-term borrowing deals structured in a such a way that a low rate of interest is usually offered for a short, initial period (anything from 1 year to 7 years), followed by a “step up” to a higher rate of interest (the “back end” interest rate), which is to be charged for the remainder of the loan period. The overall length of LOBOs is usually 40 or 50 years, but can be for shorter or longer periods. It can be attractive options bearing in mind the opportunities for very low interest rates in the primary period and competitive indicative rates thereafter. The main benefits of LOBOs include:

- Very cheap initial rates can be obtained, which cannot be matched either by long or short-term loans available elsewhere.
- Quoted rates for the remaining periods to maturity are also relatively attractive, being similar to those available from the PWLB.

5.2 The Council has LOBO loans which were taken between 2005 and 2010 as a result of proactive approach to repayment/restructuring of PWLB matured debt and the use of LOBOs are considered as part of the borrowing strategy, i.e., a LOBO with EuroHypo was secured at 3.75% as opposed to the PWLB rate at the time of 4.50%, when the market situation and difficulties in the Eurozone continues to make finding new loans difficult. In addition, the loans were taken to generate short-term savings over their primary periods compared with standard short/long-term interest rates.

5.3 The Council has a £35.9m exposure to LOBO loans at an average rate of 4.25%, and currently 16% of the total debt portfolio, of which £12.9m and £23.0m of these loans could be "called" during 2015/16 and 2016/17 respectively. The current interest rates result in very low probability of a LOBO being "called" which would trigger premature repayment. The Council will continue with the policy not to accept any option to pay a higher rate of interest on its' LOBO loans, and will exercise its own option to repay the loan should a lender exercise an option.

5.4 In conjunction with advice from the Council treasury advisor, Capita, the Council will continue to keep under review the options it has in borrowing from the PWLB, the market and other sources identified in the Treasury Management Practices, up to the available capacity within its prudential 'Authorised Limit'. While LOBO loans generally offers an initial lower rates, the PWLB remains the preferred source of borrowing given the transparency and control that its facilities continue to provide.

Appendix D

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

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

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

1.2 **Operational and authorised borrowing limits.**

The tables below sets out the estimate and projected capital financing requirement and long-term borrowing in 2013/14

	CAPITAL FINANCING REQUIREMENT	**2014/15**	**2014/15**
		Estimate **£m**	**Actual**
	Capital financing requirement at 1 April 2014	370	373
ADD	Financing of new assets	100	-
LESS	Provision for repayments of debt	-18	-12
		-------	-------
	Capital financing requirement at 31 March 2015	**450**	**361**
ADD	Net borrowing for next year	10	10
		-------	-------
	Operational boundary	**460**	**371**
ADD	Short term borrowing	20	20
		-------	-------
	Authorised limit	**480**	**391**

	ACTUAL BORROWING	**2014/15**
		Actual £m
	Long term borrowing at 1 April 2014	262.9
LESS	Loan redemption	-4.0
	Long term borrowing at 31 March 2015	**258.9**

The Capital Financing Requirement includes PFI Schemes and Finance Leases.

The actual Authorised Limit for 2014/15 of £391m reflected the move to International Financial Reporting Standards (IFRS) and previously agreed Private Finance Initiative (PFI) contracts and some leases (being reclassified as finance leases instead of operating leases) coming onto the County Council Balance Sheets as long term liabilities. This new accounting treatment impacted on the Authorised Limit.

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

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

The Authorised limit is the "Affordable Borrowing Limit" required by S3 of the Local Government Act 2003 and must not be breached. The Long Term borrowing at 31st March 2015 of £258.9m is under the Operational boundary and Authorised limit set for 2014/15. The Operational boundary and Authorised limit have not been exceeded during the year.

1.3 **Interest rate exposure**

The County Council continued the practice of seeking to secure competitive fixed interest rate exposure for 2014/15. 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.

	2014/15	**2015/16**	**2016/17**
Interest rate exposures	**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 2014/15			
	Lower	Upper	Actual 2014/15
Under 12 months	0%	25%	2%
12 months to 2 years	0%	40%	2%
2 years to 5 years	0%	60%	5%
5 years to 10 years	0%	80%	8%
10 years to 20 years	0%	80%	20%
20 years to 30 years	0%	80%	9%
30 years to 40 years	0%	80%	36%
40 years to 50 years	0%	80%	18%

The County Council has not exceeded the limits set in 2014/15. 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 will be 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 new long term borrowing will be monitored as the following targets have been set.

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

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

No new borrowing has been taken in 2014/15.

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 County Council had taken advantage of this freedom and non-Specified Investments are allowed to be held within our overall portfolio of investments and in line with our prudent approach in our strategy, no new long term investments (over 364 days) have been taken in 2013/14.

1.6 **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	172	0.57%	0.07%
May	196	0.59%	0.09%
June	191	0.60%	0.10%
July	198	0.60%	0.10%
August	196	0.60%	0.10%
September	190	0.61%	0.11%
October	188	0.62%	0.12%
November	176	0.63%	0.13%
December	180	0.62%	0.12%
January	180	0.64%	0.14%
February	162	0.65%	0.15%
March	175	0.66%	0.16%
Total for 2014/15	**2,204**	**0.62%**	**0.12%**

1.7.2. The total amount received in short term interest for the year was £2.2m at an average rate of 0.62%. This was above the average of base rates in the same period (0.5%) but ensuring, so far as possible in the financial climate, the security of principal and the minimisation of risk. This Council has continued to follow a prudent approach with security and liquidity as the main criteria before yield.

1.9 Capital Financing Requirement and Minimum Revenue Provision (MRP)

1.9.1. The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's indebtedness. The CFR results from the capital activity of the Council and resources used to pay for the capital spend. It represents the 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.

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

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

1.9.4 The total CFR can also be reduced by:

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

1.9.5. The Council's 2014/15 MRP Policy (as required by CLG Guidance) was approved as part of the Treasury Management Strategy Report for 2014/15 on 28 January 2014.

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

CFR including appropriate balances and MRP charges for PFI Schemes and Finance Leases.

	2014/15 Actual	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate
	£m	£m	£m	£m
Total CFR	**361**	**343**	**325**	**307**
Movement in CFR	**-12**	**-18**	**-18**	**-17**

Movement in CFR represented by				
Net financing need for the year	3	-4	-5	-5
MRP/VRP and other financing movements	-15	-14	-14	-13
Movement in CFR	**-12**	**-18**	**-18**	**-17**

Minimum Revenue Provision (MRP) Statement

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

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

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

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

1.14 The International Financial Reporting Standards (IFRS) involved Private Finance Initiative (PFI) contracts and some leases (being reclassified as finance leases instead of operating leases) coming onto the County Council Balance Sheets as long term liabilities. This accounting treatment impacted on the Capital Financing Requirement with the result that an annual MRP provision will be required.

1.15 The policy recommended for adoption from 1 April 2014 retained the key elements of the policy previously approved but now incorporates the IFRS changes (re PFI and finance leases) and the consequential updated Government Guidance. The policy adopted for 2014/15 is therefore as follows:-

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

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

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

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

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

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

Annex 1