Report to:	**Cabinet**
Date:	**11 December 2018**
By:	**Chief Operating Officer**
Title of report:	**Treasury Management – Stewardship Report 2017/18**
Purpose of report:	**To present a review of the Council's performance on treasury management for the year 2017/18 and Mid Year review for 2018/19.**

RECOMMENDATION: Cabinet is recommended to note the Treasury Management performance in 2017/18 incorporating the Mid Year review for the first half of 2018/19.

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, statutes and guidance. The Council has adopted the Chartered Intstitute of Public Finance and Accountancy (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 2017/18 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 2018/19 (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 2017/18

3.1 The strategy and the economic conditions prevailing in 2017/18 are set out in Appendix A which is attached to this report. 2017/18 continued the challenging environment of the previous years, with concerns over the states of the UK economy and of European countries.

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

<u>The Treasury Management Strategy</u>

4.1 The strategy for 2017/18, agreed in January 2017, 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. For the 2017/18 strategy Enhanced Money Market / Cash funds were included to manage liquidity and improve yield where possible.

<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 2017/18 was £1.3m at an average rate of 0.53%. This was above the average base rates in the same period (0.35%) 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:

- No new borrowing was undertaken in 2017/18.
- The average interest rate of all debt at 31 March 2018 (£270.8m) was 4.80%.
- Public Works Loan Board (PWLB) Debt maturing during 2017/18 totalled £4.8m and was at an average rate of 8.00%.
- 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.

Minimum Revenue Provision (MRP)

4.5 Full details of the 2017/18 MRP policy are set out in appendix D, no changes were made to the MRP policy during 2017/18.

5. Treasury Management Mid Year Review 2018/19

5.1 The Treasury Management and Annual Investment Strategy for 2018/19 were approved by the Cabinet on 23 January 2018 reflecting a revised approach to investment options. This introduced new approved instruments into the strategy with the intention of improving yield and diversification. On the 2 August 2018 the MPC increased the Bank of England base rate from 0.50% to 0.75% the average rate of return for investments to 30 September 2018 was 0.75%.

5.2 As part of the revised approach to investments in August 2018, the council invested £5m in the CCLA Property Fund, a pooled property fund. Further options to invest within the remit of the strategy will be investigated during the year.

5.3 No further PWLB borrowing was undertaken in the period and cost effective opportunities to restructure debt are currently being reviewed with our Treasury Management advisors Link Asset Services. During 2018/19 PWLB debt to mature totals £4.6m, this historic debt is at an average rate of 8%.

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. The Council is fully compliant with these indicators.

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 0.92%. The key principles of security, liquidity and yield are still relevant. Officers are currently investigating further opportunities within the strategy to minimise costs and increase investment income.

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Chief Operating Officer

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BACKGROUND DOCUMENTS

Cabinet 24 January 2017 Treasury Management Strategy for 2017/18
23 January 2018 Treasury Management Strategy for 2018/19

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 2017/18 and the economic factors affecting this strategy

1. Background information

1.1 Cabinet received an annual Treasury Management Strategy report in January 2017, 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 The original strategy for 2017/18 was drawn up in January 2017 at a time of global political uncertainty and a potential resurgence of EU sovereign debt crisis. In this climate, ensuring the security of investments continues to be paramount 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 2017/18.

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 2017, it emphasised the continued importance of credit quality. 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 Ministry of Housing, Communities & Local Government'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 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*

2.10 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.

2.11 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.

2.12 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.

2.13 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.

2.14 If investment instruments identified in the financial year under the 'Non-Specified and Specified' Investments categories were used, 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
Enhanced Money Market / Cash Funds (EMMFs)	UK/Ireland/ domiciled	AAA Bond Fund Rating	£60m	Liquidity
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
United Overseas Bank	Singapore	TD / CD's	£60m	1 yr

Counterparty	Country/ Domicile	Instrument	Maximum investments	Max. maturity period
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
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
JP Morgan Chase	U.S.A	TD / CD’s	£60m	1 yr

*Enhanced Money Market / Cash Funds were added to the 2017/18 strategy to diversify investment options.

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. Enhanced Money Market / Cash Funds were added to the 2017/18 strategy to diversify investment options.

4. Non Specified Investments

4.1 Non-Specified investments are any other types of investment that are not defined as specified. The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out below.

Non-Specified Investment	Minimum credit criteria	Maximum investments	Max. maturity period
UK Local Authorities	Government Backed	£60m	2 years
Local Capital Finance Company Limited	Local Governement Agency Backed	£100k	N/A

4.2 Non specified investments would include any sterling investments and the purchase of shares in the Municipal Bonds Agency (Local Capital Finance Company Limited). The Council will make an investment in the form of shares in the Municipal Bond 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.

4.3 The council had no exposure in Non-Specified investments during the 2017/18.

5. The economy in 2017/18 – Commentary from Link Asset Services in April 2018.

5.1 During the calendar year of 2017, there was a major shift in expectations in financial markets in terms of how soon Bank Rate would start on a rising trend. After the UK economy surprised on the upside with strong growth in the second half of 2016, growth in 2017 was disappointingly weak in the first half of the year which meant that growth was the slowest for the first half of any year since 2012.

5.2 The main reason for this was the sharp increase in inflation caused by the devaluation of sterling after the EU referendum, feeding increases into the cost of imports into the economy. This caused a reduction in consumer disposable income and spending power as inflation exceeded average wage increases. Consequently, the services sector of the economy, accounting for around 75% of GDP, saw weak growth as consumers responded by cutting back on their expenditure. However, growth did pick up modestly in the second half of 2017. Consequently, market expectations during the autumn, rose significantly that the MPC would be heading in the direction of imminently raising Bank Rate.

5.3 The minutes of the MPC meeting of 14 September indicated that the MPC was likely to raise Bank Rate very soon. The 2 November MPC quarterly Inflation Report meeting duly delivered by raising Bank Rate from 0.25% to 0.50%. The 8 February MPC meeting minutes then revealed another sharp hardening in MPC warnings on a more imminent and faster pace of increases in Bank Rate than had previously been expected. Market expectations for increases in Bank Rate, therefore, shifted considerably during the second half of 2017-18 and resulted in investment rates from 3 – 12 months increasing sharply during the spring quarter.

5.4 PWLB borrowing rates increased correspondingly to the above developments with the shorter term rates increasing more sharply than longer term rates. In addition, UK gilts have moved in a relatively narrow band this year, (within 25 bps for much of the year), compared to US treasuries. During the second half of the year, there was a noticeable trend in treasury yields being on a rising trend with the Fed raising rates by 0.25% in June, December and March, making six increases in all from the floor. The effect of these three increases was greater in shorter terms around 5 years, rather than longer term yields.

5.5 The major UK landmark event of the year was the inconclusive result of the general election on 8 June 2017. However, this had relatively little impact on financial markets.

Appendix B

The Treasury Management activity during the year 2017/18

1. Short term lending interest rates

1.1 Base interest rate was increased in November 2017 to 0.50%. The average rate for the year was 0.35%.

1.2 There have been continued uncertainties in the markets during the year as set out in Section 4 of Appendix A.

1.3 The strategy for 2017/18, agreed in January 2017, continued the prudent approach and ensured that all investments were only to the highest quality rated banks and funds using Link's colour coded credit methodology.

1.4 The total amount received in short term interest for 2017/18 was £1.3m at an average rate of 0.53%. This was above the average of base rates in the same period (0.35%) 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

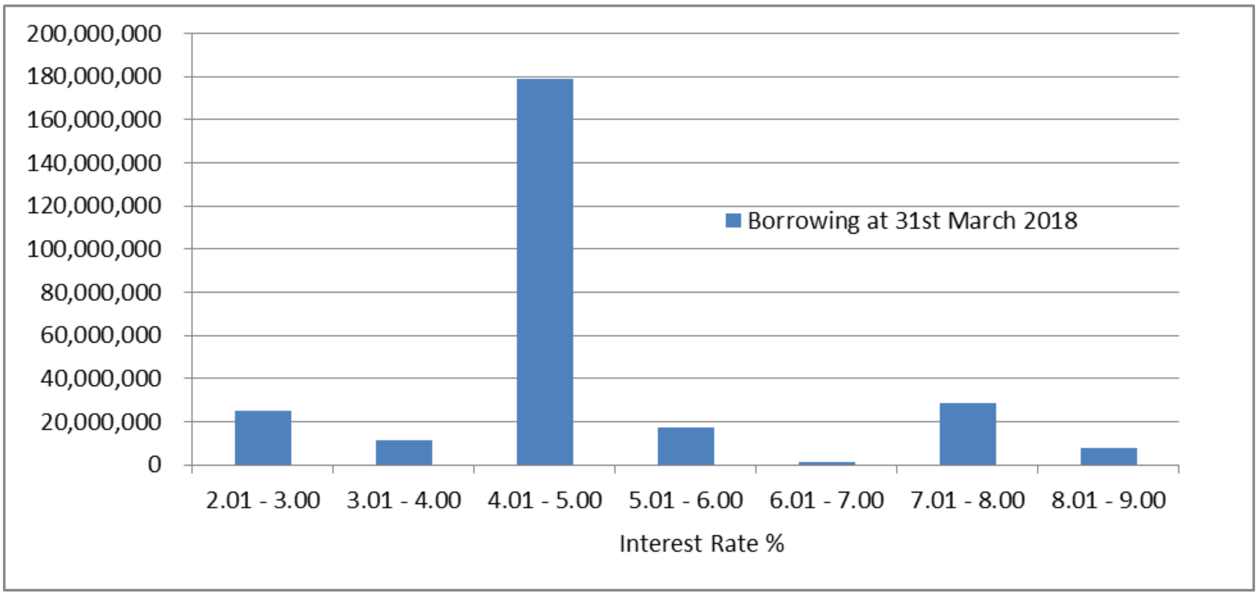
2.1 Officers constantly reviewed the need to borrow taking into consideration the potential increases in borrrowing costs, the need to finance new Capital expenditure, refinancing maturing debt, and the cost of carry that might incur a revenue loss between borrowing costs and investment returns.

2.2 During 2017/18 £4.6m of PWLB debt matured at a coupon rate of 8%. This historic maturing debt was not replaced with additional in year new borrowing.

2.3 The average interest rate of all debt at 31 March 2018 of £270.8m was 4.80%. 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 The 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 future borrowing has increased but the opportunity to restructure 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 2017/18 to date to cover temporary overdraft situations.

4. Treasury Management Advisers

4.1 The Strategy for 2017/18 explained that the Council uses Link Asset Services 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

4.2 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.

4.3 Link Asset Services 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 - 2018/19

1. Background

1.1 The Treasury Management and Annual Investment Strategy for 2018/19 were approved by the Cabinet 23 January 2018. The 2018/19 strategy broadened the approved instruments to improve yield and diversify the investment portfolio. Changes to the strategy are summarised below.

Investment option	2017/18	2018/19
Money Market Funds (Including LVNAV)	✓	✓
Bank Notice Accounts	✓	✓
Fixed Term Bank Deposits	✓	✓
UK Local Authorities	✓	✓
Enhanced Money Market Funds (VNAV)	✓	✓
Building Societies	✗	✓
Pooled Property Funds	✗	✓
Corporate Bond Funds	✗	✓
Multi Asset Funds	✗	✓
Equity Funds	✗	✗

1.2 This report considers treasury management activity over six months of the financial year.

2. Summary of financial implications

2.1 During the first half year investments have been held in bank notice accounts, 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.

2.2 The Bank of England's Monetary Policy Committee increased the official Bank Rate on 2 August 2018 from 0.50% to 0.75%

2.3 In line with the revised annual investment strategy, in August 2019 the council invested £5m in the CCLA Local Authority Property Fund, a pooled property vehicle. Net yield on this fund for the quarter to 30 September 2018 was 4.07% which equates to £34k of income. This compares to an average rate of 0.75% for 6 months on the remainder of the councils investment portfolio.

2.4 The use of Multi Asset Funds will be explored with our treasury advisors Link Asset Services.

2.5 The average investment balance to September 2018 was £250m and generated investment income of £935k. The forecast for 2018/19 is £2.0m.

2.6 The level of Council debt at 30 September 2018 was £269m with two loans totalling £3.3m maturing with the PWLB in the next 6 months to 31st March 2019. The forecast for interest paid on long-term debt in 2018/19 is approximately £12.83m and is within the budgeted provision.

2.7 Opportunities to reduce the cost of carry (interest paid against interest received) are being explored as and when options arise. A new opportunity to reduce the cost of carry by restructuring £23.5m of the council's LOBO loans has arisen, which is currently being explored.

3. Treasury Management Strategy

3.1 The Council approved the 2018/19 treasury management strategy at its meeting on 23 January 2018. 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.

3.2 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.

3.3 The Chief Finance Officer is pleased to report that all treasury management activity undertaken from April 2018 to September 2018 period complied with the approved strategy, the CIPFA Code of Practice, and the relevant legislative provisions.

4. Economic Review (provided by Link Asset Services, October 2018)

4.1 The first half of 2018/19 has seen UK economic growth post a modest performance, but sufficiently robust for the Monetary Policy Committee, (MPC), to unanimously (9-0) vote to increase Bank Rate on 2nd August from 0.5% to 0.75%. Although growth looks as if it will only be modest at around 1.5% in 2018, the Bank of England's August Quarterly Inflation Report suggested that growth will pick up to 1.8% in 2019, albeit there were several caveats – mainly related to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.

4.2 Some MPC members have expressed concerns about a build-up of inflationary pressures, particularly with the pound falling in value again against both the US dollar and the Euro. The Consumer Price Index (CPI) measure of inflation is currently running at 2.5% but is expected to fall back towards the 2% inflation target over the next two years given a scenario of minimal increases in Bank Rate. The MPC has indicated Bank Rate would need to be in the region of 1.5% by March 2021 for inflation to stay on track. Financial markets are currently pricing in the next increase in Bank Rate for the second half of 2019.

4.3 Unemployment is now at a 43 year low of 4% on the Independent Labour Organisation measure, but despite that, wage inflation is currently not overly-strong at 2.6% (including bonuses). This is a global theme for the major economies of the world. Indeed, with UK wages running in line with the CPI measure of inflation, real earnings are, in effect, neutral. Given the UK economy is very much services sector driven, any weakness in household spending power is likely to feed through into tepid economic growth.

4.4 The MPC will need to tread cautiously before increasing Bank Rate again, especially given all the uncertainties around Brexit. Additionally, business sentiment surveys, such as the Purchasing Managers Index collated by Markit, suggest the UK is set for only modest GDP growth in the second half of 2018 with the monthly updated figure for annual growth being 1.5% as at the end of July. The housing market is going through a weak phase – with UK-wide house price growth averaging 2 to 3%, but with London and the south-east experiencing price falls.

5.0 Link Asset Services (LAS) forecasts

5.1 The flow of generally positive economic statistics after the end of the quarter ended 30 June meant that it came as no surprise that the MPC came to a decision on 2 August to make the first increase in Bank Rate above 0.5% since the financial crash, to 0.75%. However, the MPC emphasised again, that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary of contractionary), than before the crash; indeed they gave a figure for this of around 2.5% in ten years' time but they declined to give a medium term forecast.

5.2 LAS do not think that the MPC will increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. We also feel that the MPC is more likely to wait until August 2019, than May 2019, before the next increase, to be followed by further increases of 0.25% in May and November 2020 to reach 1.5%. However, the cautious pace of even these limited increases is dependent on a reasonably orderly Brexit.

5.3 LAS, has provided the following forecast:

	Link Asset Services Interest Rate View										
	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate View	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%
3 Month LIBID	0.75%	0.80%	0.80%	0.90%	1.10%	1.10%	1.20%	1.40%	1.50%	1.60%	1.60%
6 Month LIBID	0.85%	0.90%	0.90%	1.00%	1.20%	1.20%	1.30%	1.50%	1.60%	1.70%	1.70%
12 Month LIBID	1.00%	1.00%	1.00%	1.10%	1.30%	1.30%	1.40%	1.60%	1.70%	1.80%	1.80%
5yr PWLB Rate	2.00%	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%
10yr PWLB Rate	2.40%	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%
25yr PWLB Rate	2.80%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%
50yr PWLB Rate	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%

6. Borrowing advice:

6.1 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, councils 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 1.50% by March 2021.

Appendix D

1. 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 2.1 below)
- Interest rate exposure (paragraph 3.1 below)
- Interest rate on long term borrowing (paragraph 4.1 below)
- Maturity structure of investments (paragraph 5.1 below)
- Compliance with the Treasury Management Code of Practice (paragraph 6.1 below)
- Interest on investments (paragraph 7.1 below)
- Capital Financing Requirement and Minimum Revenue Provision (paragraph 8.1 below)

2. Operational and authorised borrowing limits.

2.1 The tables below sets out the estimate and projected Capital financing requirement and long-term borrowing in 2017/18

	Capital Financing Requirement	**2017/18 Estimate**	**2017/18 Actual**
		£m	**£m**
	Capital Financing Requirement at 1 April 2017	**352**	**335**
add	Financing of new assets	26	12
less	Provision for repayment of debt	(12)	(12)
less	Long term Capital loan*	-	1
	Capital Financing Requirement at 31 March 2018	**366**	**336**
add	Short Term Borrowing Provision	10	
	Operational Boundary	**376**	
add	Short Term Borrowing Provision	20	
	Authorised Limit	**396**	

	Actual Borrowing	**2017/18 Actual**
		£m
	Long Term Borrowing at 1 April 2017	**275**
less	Loan redemptions	(4)
add	New Borrowing	-
	Long Term Borrowing at 31 March 2018	**271**

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

2.2 The Capital Financing Requirement includes PFI Schemes and Finance Leases totalling £90m resulting in an underlying need to borrow of £246m.

2.3 The Operational Boundary 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. 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 Operational boundary represents a key management tool for in year monitoring and long term borrowing control.

2.4 The Authorised Limit for borrowing was based on the same estimates as the Operational Boundary but includes additional headroom for a short term borrowing to allow, for example, for unusual cash movements or late receipt of income.

2.5 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 2018 of £270.8m is under the Operational boundary and Authorised limit set for 2017/18. The Operational boundary and Authorised limit have not been exceeded during the year.

3. Interest rate exposure

3.1 The Council continued the practice of seeking to secure competitive fixed interest rate exposure for 2017/18. 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.

	2017/18	**2018/19**	**2019/20**
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 2017/18			
	Lower	**Upper**	**Actual 2017/18**
Under 12 months	0%	25%	4%
12 months and within 24 months	0%	40%	2%
24 months and within 5 years	0%	60%	13%
5 years and within 10 years	0%	80%	9%
10 years and within 20 years	0%	80%	22%
20 years and within 30 years	0%	80%	18%
30 years and within 40 years	0%	80%	29%
40 years and above	0%	80%	2%

3.2 The Council has not exceeded the limits set in 2017/18. 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. 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.

4. Interest rate on long term borrowing

4.1 The rate of interest taken on any new long term borrowing has been defined with the assistance of Link Asset Services. 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.

5. Maturity structure of investments

5.1 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.

6. Compliance with the Treasury Management Code of Practice

6.1 East Sussex County Council has adopted the Chartered Institute of Public Finance and Accountancy (CIPFA), Code of Practice for Treasury Management in the Public Services. In December 2017, CIPFA, issued a revised Treasury Management Code and Cross Sectoral Guidance Notes, and a revised Prudential Code.
A particular focus of these revised codes was how to deal with local authority investments which are not treasury type investments e.g. by investing in purchasing property in order to generate income for the Authority at a much higher level than can be attained by treasury investments. The outcome is a new Capital Strategy document which will be presented to Cabinet as part of the 2019/20 budget papers.

7. Interest on investments

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	110	0.52%	0.27%
May	112	0.53%	0.28%
June	95	0.47%	0.22%
July	103	0.46%	0.21%
August	103	0.47%	0.22%
September	99	0.47%	0.22%
October	106	0.47%	0.22%
November	120	0.55%	0.06%
December	123	0.59%	0.09%
January	126	0.61%	0.11%
February	111	0.60%	0.10%
March	124	0.61%	0.11%
Total for 2017/18	**1,332**	**0.53%**	**0.18%**

7.2 The total amount received in short term interest for the year was £1.3m at an average rate of 0.53%. This was above the average of base rates in the same period (0.35%) 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.

8. Capital Financing Requirement and Minimum Revenue Provision (MRP)

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 2017/18 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.

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.

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.

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).

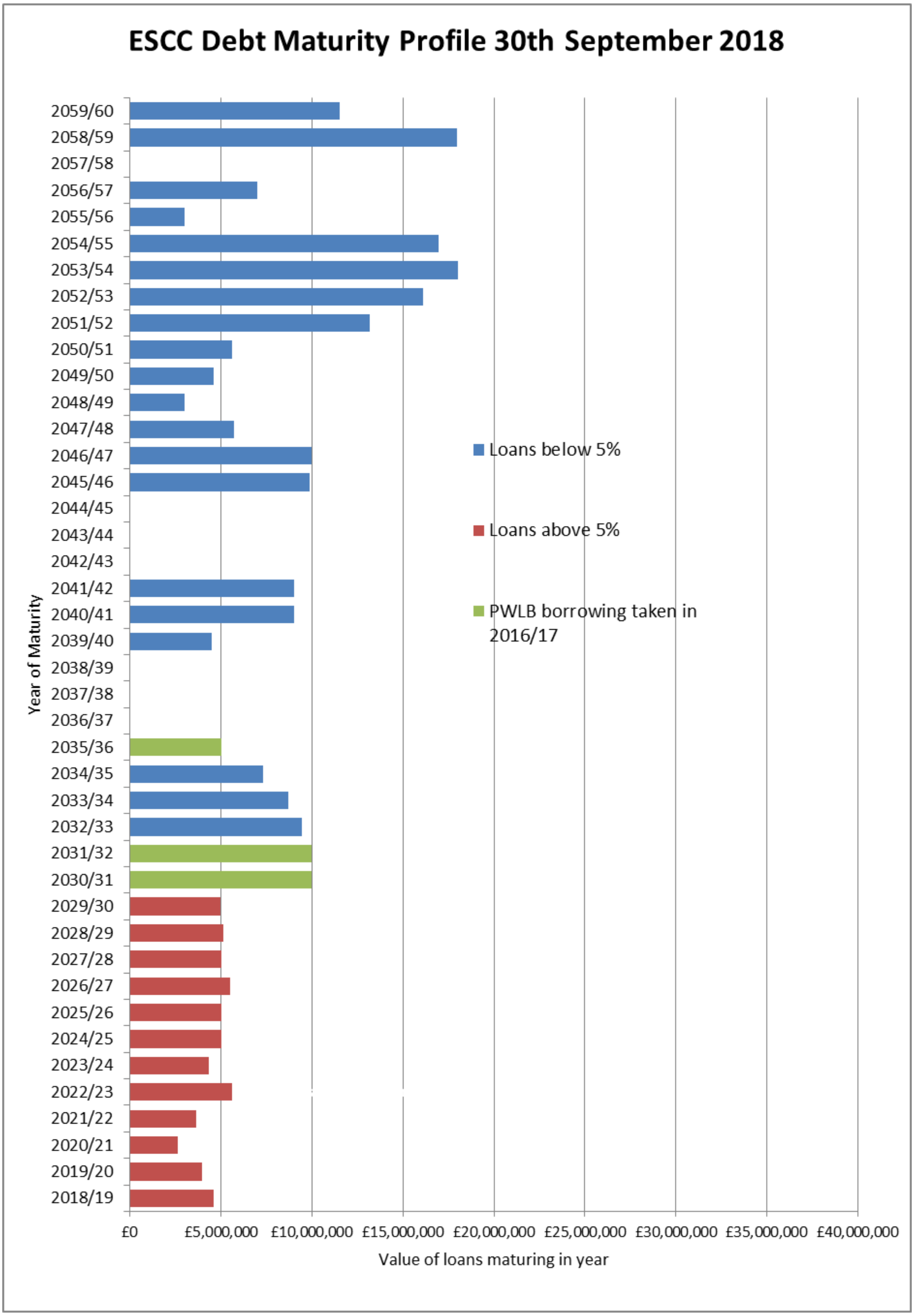
8.5 The Council's 2017/18 MRP Policy (as required by Ministry of Housing, Communities & Local Government Guidance) was approved as part of the Treasury Management Strategy Report for 2018/19 on 23 January 2018.

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.

	2017/18 Actual	**2018/19 Estimate**	**2019/20 Estimate**	**2020/21 Estimate**
	£m	**£m**	**£m**	**£m**
Total CFR	**336**	**347**	**364**	**378**
Movement in CFR	-	11	17	14

Annex 1



ESCC Debt Maturity Profile 30th September 2018
Year of Maturity
2059/60
2058/59
2057/58
2056/57
2055/56
2054/55
2053/54
2052/53
2051/52
2050/51
2049/50
2048/49
2047/48
2046/47
2045/46
2044/45
2043/44
2042/43
2041/42
2040/41
2039/40
2038/39
2037/38
2036/37
2035/36
2034/35
2033/34
2032/33
2031/32
2030/31
2029/30
2028/29
2027/28
2026/27
2025/26
2024/25
2023/24
2022/23
2021/22
2020/21
2019/20
2018/19
Loans below 5%
Loans above 5%
PWLB borrowing taken in 2016/17
£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