Report to:	**Cabinet**
Date:	**10 December 2019**
By:	**Chief Operating Officer**
Title of report:	**Treasury Management – Stewardship Report 2018/19**
Purpose of report:	**To present a review of the Council's performance on treasury management for the year 2018/19 and Mid Year review for 2019/20.**

RECOMMENDATION: The Cabinet is recommended to note the Treasury Management performance in 2018/19 incorporating the Mid Year review for the first half of 2019/20.

1. Background

1.1 The annual stewardship report presents the Council's treasury management performance for 2018/19 and Mid Year performance for 2019/20, as 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 CIPFA Code of Practice for Treasury Management in the Public Sector and operates the treasury management function 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 performance review (this Stewardship Report).

2.2 This report sets out:

- A summary of the original strategy agreed for 2018/19 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 2019/20 (Appendix C);
- The Prudential Indicators, which relate to the Treasury Management function, Minimum Revenue Policy (MRP) and compliance with limits (Appendix D).

3. The economic conditions compared to our Strategy for 2018/19

3.1 The strategy and the economic conditions prevailing in 2018/19 are set out in Appendix A. 2018/19 remained a challenging environment with concerns over the UK, European and global economies rising.

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

<u>The Treasury Management Strategy</u>

4.1 The strategy for 2018/19, agreed in February 2018, continued the prudent approach and ensured that all investments were only to the highest quality rated institutions with regard to security, liquidity and yield. For banks the maximum investment period was one year and for other local authority lending two years. For the 2018/19 strategy Building Societies, Pooled Property Funds, Corporate Bond Funds and Multi Asset Funds were included to broaden the risk profile by reducing liquidity and to include suitable, alternative investment products.

Short term lending

4.2 At the Monetary Policy Committee (MPC) meeting 2 August 2018, the MPC voted unanimously to increase the Bank of England base rate from 0.50% to 0.75%.

4.3 The total amount received in short term interest for 2018/19 was £2.1m at an average rate of 0.89%. This was above the average base rates in the same period (0.67%) and above the average returns achieved with peer authorities from treasury advisors (Link Asset Services) investment benchmarking. The Return for 2018/19 was against a backdrop of ensuring, so far as possible in the current financial climate, the security of principal and the minimisation of risk with a view to broaden options where appropriate.

Longer term lending

4.4 As part of the revised approach to investments in August 2018, the council invested £5m in the CCLA Property Fund, a pooled property fund. The return to date has been £230k.

Long term borrowing

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

- No new borrowing was undertaken in 2018/19.
- The average interest rate of all debt at 31 March 2019 (£243m) was 4.77%.
- A restructuring opportunity arose in October 2018, with one of the council's market lenders (RBS) offering to allow the council to repay £23m loans on attractive terms. The Council funded the repayment through using cash within the investment portfolio, thereby reducing the overborrowed position of the Council's Capital Financing Requirement (CFR).
- Public Works Loan Board (PWLB) Debt maturing during 2018/19 totalled £4.67m and was at an average rate of 8.13%.

Minimum Revenue Provision (MRP)

4.6 Full details of the 2018/19 MRP policy are set out in appendix D, the policy was reviewed and following consultation with Audit Committee on 20 September 2018, updated and formally approved at Full Council on the 5 February 2019.

5. Treasury Management Mid Year Review 2019/20

5.1 The Treasury Management and Annual Investment Strategy for 2019/20 were approved by Full Council on 5 February 2019 and was prepared within the context of the financial challenge being faced by the County Council.

5.2 The total amount received in short term interest for 6 months to 30 September 2019 was £1.2m at an average rate of 1.06%. This was above the average base rates in the same period (0.75%) and investment benchmarking with peer authorities.

5.3 No further PWLB borrowing was undertaken in the period and no cost effective opportunities to restructure debt have taken place. During 2019/20 PWLB to mature totals £3.9m, this historic debt is at an average rate of 8.17%. Taking total debt down to £239.2m by 31 March 2020.

5.4 On the 9 October the Government announced an unexpected increase to the PWLB interest rate for all new loans. The increase added 1% (100bps) to the cost of borrowing. It also increased the statutory limit on how much the PWLB can have lent out at once, from £85bn to £95bn. The increase to future borrowing cost will have an impact and will be factored into the development of the 2020/21 to 2029/30 Capital Strategy.

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, 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 18 month period covered achieved returns between 0.65% and 1.08%. 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 within the key principles.

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Chief Operating Officer

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BACKGROUND DOCUMENTS

Cabinet 23 January 2018 Treasury Management Strategy for 2018/19
22 January 2019 Treasury Management Strategy for 2019/20

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 2018/19 and the economic factors affecting this strategy

1. Background information

1.1 Full Council approved the annual Treasury Management Strategy report in February 2018, 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 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 2018/19 was drawn up outling various options for increasing investment income. Details of the changes proposed to investment and borrowing investment strategies include:

- Seek to reduce liquidity where possible and extend duration of investments within current limits. A sensible rebalancing of liquidity requirements will improve yield without significant additional risk;
- Wider use of other Local Authorities and Building Societies where rates are favourable;
- Inclusion of Short Dated Bond Funds and Corporate Bonds;
- Inclusion of pooled property funds and pooled mixed asset funds. Given the low returns from short-term bank investments, the Council will diversify with the use of pooled funds. With the assistance of the Council's treasury advisors (Link Asset Services), a selection process will take place in the new year where members and officers can scrutinise a suitable selection of funds;
- No external borrowing was planned for 2018/19; officers will be monitoring the situation in the next 12 months. Officers continue to regularly review opportunities for debt rescheduling, PWLB debt restructuring is now much less attractive as 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.

1.4 At the same time, the Treasury Management Policy Statement was agreed as unchanged for 2018/19.

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 2018, 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. 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 within the key principles.

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 al Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second, and then return.

2.8 Investment instruments identified for use in the financial year are listed in section 3.2 and 4.1 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 AA+ 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

Counterparty	Country/ Domicile	Instrument	Maximum investments	Max. maturity period
Goldman Sachs Investment Bank	UK		£60m	1 yr
Standard Chartered Bank	UK		£60m	1 yr
Nationwide Building Society	UK		£60m	1 yr
Coventry Building Society	UK		£60m	1yr
Individual Money Market Funds (MMF) CNAV and LVNAV	UK/Ireland/ domiciled	AAA rated Money Market Funds	£60m	Instant access
VNAV MMF's and Ultra Short Dated Bond Funds	UK/Ireland/ domiciled	AAA Bond Fund Rating	£60m	Liquidity up to 1 yr
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
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
Cooperative 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

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
Corporate Bond Fund(s)	Investment Grade	£30m	2-5 years
Pooled Property Fund(s)	N/A	£30m	5+ years
Mixed Asset Fund(s)	Appropriate rating	£30m	2-5 years

4.2 The maximum amount that can be invested will be monitored in relation to the Council surplus monies and the level of reserves. The approved counterparty list will be maintained by referring to an up-to-date credit rating agency reports, and the Council will liaise regularly with brokers for updates. Counterparties may be added to or removed from the list only with the approval of the Chief Finance Officer.

4.3 **UK Local Authorities:** Should a suitable opportunity in the market occur to lend to other Local Authorities of more than a 1 year duration, at a reasonable level of return the deal would be classed as a low risk Non-Specified Investment.

4.4 **Corporate Bonds:** The Ministry of Housing, Communities and Local Government recently changed the rules on capital expenditure for English Local Authorities, meaning that investing in corporate bonds was no longer classified as capital spending. In essence, companies issue bonds in order to raise long-term capital or funding, rather than issuing equity. These are non-standardised compared to other investment vehicles, each having an individual legal document known as a 'bond indenture'. The document specifies the rights of the holder and the obligations that must be met by the issuer, as well as the characteristics of that particular bond. Investing in a corporate bond usually offers a fixed stream of income (except floating rate notes), known as a coupon, payable twice a year, for a fixed, pre-determined period of time, in exchange for an initial investment of capital.

4.5 **Investment in Pooled Property Fund(s):** Local authorities have for many years invested in non-liquid assets or property by directly purchasing properties, but a simpler and more efficient route would be to invest in an appropriate property unit trust. This is a more diversified form of investment than an individual purchase of property and would give greater geographic spread and access to assets that the Council could not afford to own through use of its own resources. Property investment should be considered as a long term investment and should only be committed to if the Council is prepared to accept that in some years capital values may decline, but in the longer run capital growth should be possible. If a fund achieves its objectives then the Council will achieve capital growth and reasonable returns. Property Funds offer all the advantages of a professionally managed property portfolio, with broadly diversified exposure to high quality properties in the strongest areas of the market. By investing in the Fund, the Council avoid the potential problems, costs and administrative difficulties of investing in properties directly. Officers in conjunction with the Council's treasury advisors will be reviewing investment options within the area of Property Fund's and make use of them as and when sufficient due diligence has been undertaken.

5. The economy in 2018/19 – Commentary from Link Asset Services in April 2019.

5.1 After weak economic growth of only 0.2% in quarter one of 2018/19, growth picked up to 0.4% in quarter 2 and to a particularly strong 0.7% in quarter 3, before cooling off to 0.2% in the final quarter. Given all the uncertainties over Brexit, this weak growth in the final quarter was as to be expected. However, some recovery in the rate of growth is expected going forward. The annual growth in Q4 came in at 1.4% y/y confirming that the UK was the third fastest growing country in the G7 in quarter 4

5.2 The Monetary Policy Committee raised the Bank Rate from 0.5% to 0.75% in August 2018 and it is little surprise that they have abstained from any further increases since then. We are unlikely to see any further action from the MPC until the uncertainties over Brexit clear. If there were a disorderly exit, it is likely that Bank Rate would be cut to support growth.

5.3 Nevertheless, the MPC has been having increasing concerns over the trend in wage inflation which peaked at a new post financial crisis high of 3.5%, (excluding bonuses), in the three months to December before falling only marginally to 3.4% in the three months to January. British employers ramped up their hiring at the fastest pace in more than three years in the three months to January as the country's labour market defied the broader weakness in the overall economy as Brexit approached.

5.4 CPI inflation has been on a falling trend since peaking at 3.1% in November 2017, reaching a new low of 1.8% in January 2019 before rising marginally to 1.9% in February. However, in the February 2019 Bank of England Inflation Report, the latest forecast for inflation over both the two and three year time horizons remained marginally above the MPC’s target of 2%.

5.5 The major UK news event of the year was the ongoing arrangements for Brexit. The Conservative minority government was unable to muster a majority in the Commons over its Brexit deal. The EU deadline of April 12 for the House of Commons to propose what form of Brexit it would support was not met. The now extended deadline of the 31st October is the next key milestone in the Brexit process.

5.6 However the degree of disagreement within each of the two main political parties is probably now even greater than before the initial deadline; this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

Appendix B

The Treasury Management activity during the year 2018/19

1. Investment activity interest rates

1.1 Following consultation, the strategy for 2018/19 aimed to broaden the risk profile by reducing liquidity and to include some suitable, alternative investment products that are held for the medium (2-5 years) to longer term (5 years+). These products can generate better overall returns but there is a higher risk of volatility of performance so a longer term commitment is required. The inclusion of an investment product category in the strategy does not automatically result in investments being placed. Following due diligence, each investment decision considers the relative risks, returns and cash flow requirements within the context of the full investment portfolio.

1.2 The revised broader group of investment instruments included pooled property funds, short dated bond funds, and pooled mixed asset funds. The inclusion of these instruments provides options for the Council to invest its longer term cash, which assists in both diversifying the investment portfolio whilst providing an improvement to the overall yield. The council's first step in using these wider instruments was with a £5m investment in the CCLA Pooled Property fund in July 2018 following a fund selection process. In its first 12 months, this investment achieved an annualised yield of 3% over and above what the council could achieve for one year deposits with banks at the time.

1.3 Base interest rate was increased in August 2018 to 0.75%. The average rate for the year was 0.67%.

1.4 The total amount received in short term interest for 2018/19 was £2.1m at an average rate of 0.89%. This was above the average of base rates in the same period (0.67%) and against a backdrop of ensuring, so far as possible in the financial climate, the security of principal and the minimisation of risk within a broader boundary.

2. Long term borrowing

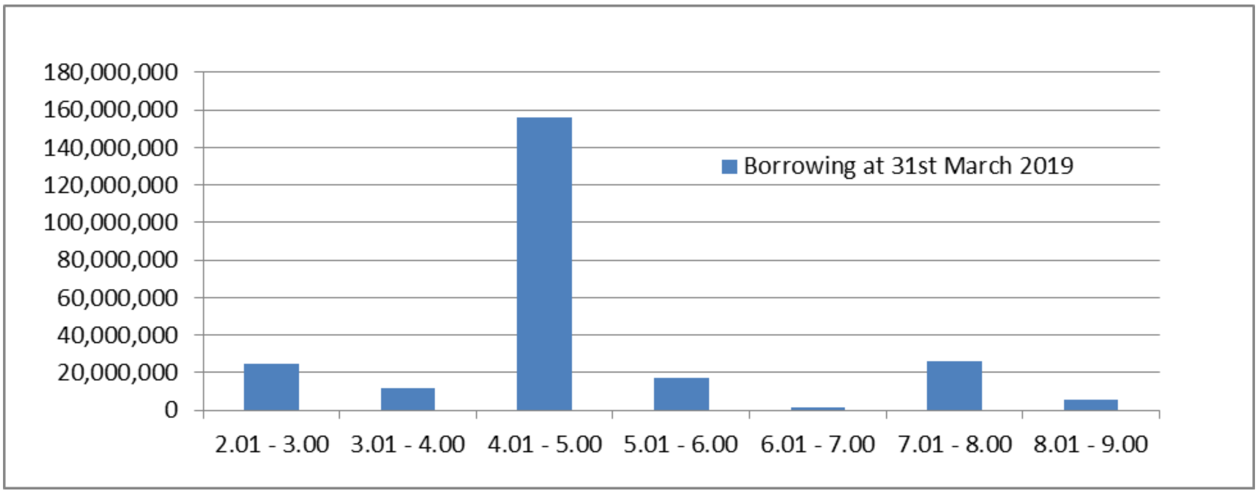
2.1 Officers constantly reviewed the need to borrow taking into consideration the potential movements in borrrowing costs, the need to finance new capital expenditure, refinancing maturing debt, and the cost of carry that might incur a revenue loss between borrowing costs and investment returns.

2.2 During 2018/19 £4.67m of PWLB debt matured at a coupon rate of 8.13%. 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 2019 of £243m was 4.77%. 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 A restructuring opportunity arose in October 2018, with one of the council's market lenders (RBS) offering to allow the council to repay the £23m loans on attractive terms. The Council funded the repayment through using cash within the investment portfolio, thereby reducing the overborrowed position of the Council's CFR.

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 2018/19 to date to cover temporary overdraft situations.

4. Treasury Management Advisers

4.1 The Strategy for 2018/19 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 - 2019/20

1. Background

1.1 The Treasury Management and Annual Investment Strategy for 2019/20 were approved by the Cabinet 22 January 2019. The 2019/20 strategy broadened the approved instruments to improve yield and diversify the investment portfolio. Changes to the strategy are summarised below.

Investment option	2018/19	2019/20
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, other local authorities and the CCLA Local Authority Property Fund. 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 have held interest rates at 0.75% over the period.

2.3 The average investment balance to September 2019 was £224m and generated investment income of £1.12m. The forecast for 2019/20 is £2.3m.

2.4 The level of Council debt at 30 September 2019 was £242m with two loans totalling £2.6m maturing with the PWLB in the next 6 months to 31st March 2020. The forecast for interest paid on long-term debt in 2019/20 is approximately £11.45m and is within the budgeted provision.

2.5 Opportunities to reduce the cost of carry (interest paid against interest received) are constanly being explored as and when options arise.

3. Treasury Management Strategy

3.1 The Council approved the 2019/20 treasury management strategy at its meeting on 22 January 2019. 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 Council is exploring with its Treasury Adviosrs the use of pooled property, mixed asset funds and equity funds. However in the current climate political and economic climate the timing of investment must be a consideration.

3.4 The Chief Finance Officer is pleased to report that all treasury management activity undertaken from April 2019 to September 2019 period complied with the approved strategy, the CIPFA Code of Practice, and the relevant legislative provisions.

4. Economic Review (provided by Link Asset Services, November 2019)

4.1 2019 has been a year of upheaval on the political front as Theresa May resigned as Prime Minister to be replaced by Boris Johnson on a platform of the UK leaving the EU on 31 October 2019, with or without a deal. However, MPs blocked leaving on that date and the EU has agreed an extension to 31 January 2020.

4.2 In addition, a general election has been called for 12 December 2019. Given the uncertainty about the result of the general election and what MPs could afterwards decide, any interest rate forecasts are subject to material change as this situation evolves.

4.3 The first half of 2019/20 has seen UK economic growth fall as Brexit uncertainty took a toll. In its Inflation Report of 1 August, the Bank of England was notably downbeat about the outlook for both the UK and major world economies. The MPC meeting of 19 September reemphasised their concern about the downturn in world growth and also expressed concern that the prolonged Brexit uncertainty would contribute to a build-up of spare capacity in the UK economy, especially in the context of a downturn in world growth. This mirrored investor concerns around the world which are now expecting a significant downturn or possibly even a recession in some major developed economies.

4.4 The Monetary Policy Committee (MPC) left Bank Rate unchanged at 0.75% throughout 2019, so far, and is expected to hold off on changes until there is some clarity on what is going to happen over Brexit. However, it is also worth noting that the new Prime Minister is making some significant promises on various spending commitments and a relaxation in the austerity programme. This will provide some support to the economy and, conversely, take some pressure off the MPC to cut Bank Rate to support growth.

4.5 Inflation (CPI) has been hovering around the Bank of England's target of 2% during 2019, but fell to 1.7% in August. It is likely to remain close to 2% over the next two years and so it does not pose any immediate concern to the MPC at the current time. However, if there was a no deal Brexit, inflation could rise towards 4%, primarily as a result of imported inflation on the back of a weakening pound.

4.6 The labour market, despite the contraction in quarterly GDP growth of -0.2%q/q, (+1.3% y/y), in quarter 2, employment continued to rise, but at only a muted rate of 31,000 in the three months to July after having risen by no less than 115,000 in quarter 2 itself: the latter figure, in particular, suggests that firms are preparing to expand output and suggests there could be a return to positive growth in quarter 3. Unemployment continued at a 44 year low of 3.8% on the Independent Labour Organisation measure in July and the participation rate of 76.1% achieved a new all-time high. Job vacancies fell for a seventh consecutive month after having previously hit record levels. However, with unemployment continuing to fall, this month by 11,000, employers will still be having difficulty filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to a high point of 3.9% in June before easing back slightly to 3.8% in July, (3 month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 2.1%. As the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months.

4.7 The latest GDP statistics also included a revision of the savings ratio from 4.1% to 6.4% which provides reassurance that consumers' balance sheets are not over stretched and so will be able to support growth going forward. This would then mean that the MPC will need to consider carefully at what point to take action to raise Bank Rate if there is an agreed Brexit deal, as the recent pick-up in wage costs is consistent with a rise in core services inflation to more than 4% in 2020.

5.0 Link Asset Services (LAS) forecasts (November 2019)

5.1 LAS do not currently suggest that the MPC would increase Bank Rate before any clearing of the fog on Brexit and agreement being reached on a UK/EU trade deal. They have moved back their forecast for the first increase from quarter 4 2020 to quarter 1 2021 and the second increase from quarter 1 2021 to quarter 2 2021.

5.2 Forecasts for average investment earnings beyond the three year time horizon will be heavily dependent on economic and political developments.

5.3 LAS, has provided the following forecast:

Link Asset Services Interest Rate View	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
Bank Rate View	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.25	1.25	1.25	1.25
3 Month LIBID	0.70	0.70	0.70	0.80	0.90	1.00	1.00	1.00	1.10	1.20	1.30	1.30	1.30	1.30
6 Month LIBID	0.80	0.80	0.80	0.90	1.00	1.10	1.10	1.20	1.30	1.40	1.50	1.50	1.50	1.50
12 Month LIBID	1.00	1.00	1.00	1.10	1.20	1.30	1.30	1.40	1.50	1.60	1.70	1.70	1.70	1.70
5yr PWLB Rate	2.30	2.40	2.40	2.50	2.50	2.60	2.70	2.80	2.90	2.90	3.00	3.10	3.20	3.20
10yr PWLB Rate	2.60	2.70	2.70	2.70	2.80	2.90	3.00	3.10	3.20	3.20	3.30	3.30	3.40	3.50
25yr PWLB Rate	3.20	3.30	3.40	3.40	3.50	3.60	3.70	3.70	3.80	3.90	4.00	4.00	4.10	4.10
50yr PWLB Rate	3.10	3.20	3.30	3.30	3.40	3.50	3.60	3.60	3.70	3.80	3.90	3.90	4.00	4.00

6. Borrowing advice:

6.1 PWLB rates have fallen significantly up until 100 bps were added to all PWLB rates in October 2019. As the current long term forecast for Bank Rate is 2.25%, and all PWLB certainty rates are above 2.25%, there is little value in borrowing from the PWLB. Accordingly, the authority will need to reassess its risk appetite in terms of either seeking cheaper alternative sources of borrowing or switching to short term borrowing in the money markets until such time as the Government might possibly reconsider the margins charged over gilt yields.

6.2 Any new borrowing should also take into account the continuing cost of carry, the difference between investment earnings and borrowing rates.

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 2018/19

	Capital Financing Requirement	**2018/19 Estimate**	**2018/19 Actual**
		£m	**£m**
	Capital Financing Requirement at 1 April 2018	**341**	**336**
add	Financing of new assets	18	2
add	Long Term Loans	-	1
less	Provision for repayment of debt	(12)	(10)
	Capital Financing Requirement at 31 March 2019	**347**	**329**
add	Short Term Borrowing Provision	10	
	Operational Boundary	**357**	
add	Short Term Borrowing Provision	20	
	Authorised Limit	**377**	

	Actual Borrowing	**2018/19 Actual**
		£m
	Long Term Borrowing at 1 April 2018	**271**
less	Loan redemptions	(28)
add	New Borrowing	-
	Long Term Borrowing at 31 March 2019	**243**

*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 £89m, excluding these results in an underlying need to borrow of £239m.

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 2019 of £243m is under the Operational boundary and Authorised limit set for 2018/19. 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 2018/19. 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.

	2018/19	**2019/20**	**2020/21**
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 2018/19			
	Lower	**Upper**	**Actual 2018/19**
Under 12 months	0%	25%	1%
12 months and within 24 months	0%	40%	2%
24 months and within 5 years	0%	60%	6%
5 years and within 10 years	0%	80%	11%
10 years and within 20 years	0%	80%	23%
20 years and within 30 years	0%	80%	22%
30 years and within 40 years	0%	80%	37%
40 years and above	0%	80%	0%

3.2 The Council has not exceeded the limits set in 2018/19. 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 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 was 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	130	0.65%	0.15%
May	151	0.71%	0.21%
June	138	0.68%	0.18%
July	151	0.69%	0.19%
August	193	0.82%	0.07%
September	206	0.92%	0.17%
October	205	0.97%	0.22%
November	184	1.00%	0.25%
December	192	1.04%	0.29%
January	196	1.06%	0.31%
February	177	1.06%	0.31%
March	192	1.08%	0.33%
Total for 2018/19	**2,116**	**0.89%**	**0.22%**

7.2 The total amount received in short term interest for the year was £2.1m at an average rate of 0.89%. This was above the average of base rates in the same period (0.67%) 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 is required to pay off an element of the accumulated General Fund capital spend each year (the Capital Financing Requirement - CFR) through a revenue charge (the minimum revenue provision - MRP). Ministry of Housing, Communities and Local Government (MHCLG) regulations require the full Council to approve an MRP Statement in advance of each year. A variety of options are available to councils, so long as the principle of any option selected ensures a 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).

8.2 The below 2018/19 MRP Policy Statement reflects a change in policy for borrowing incurred both before and after 2008. The Policy (as required by Ministry of Housing, Communities & Local Government Guidance) was approved as part of the Treasury Management Strategy Report for 2019/20 on 22 January 2019.

8.3 The Council was recommended to approve the following MRP Statement for 2018/19 onwards:

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

- Annuity basis over a maximum of 40 years.

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

- Asset Life Method (annuity method) – MRP will be based on the estimated life of the assets, in accordance with the proposed regulations. A maximum useful economic life of 50 years for land and 40 years for other assets. This option will also be applied for any expenditure capitalised under a capitalisation directive.

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

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

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

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

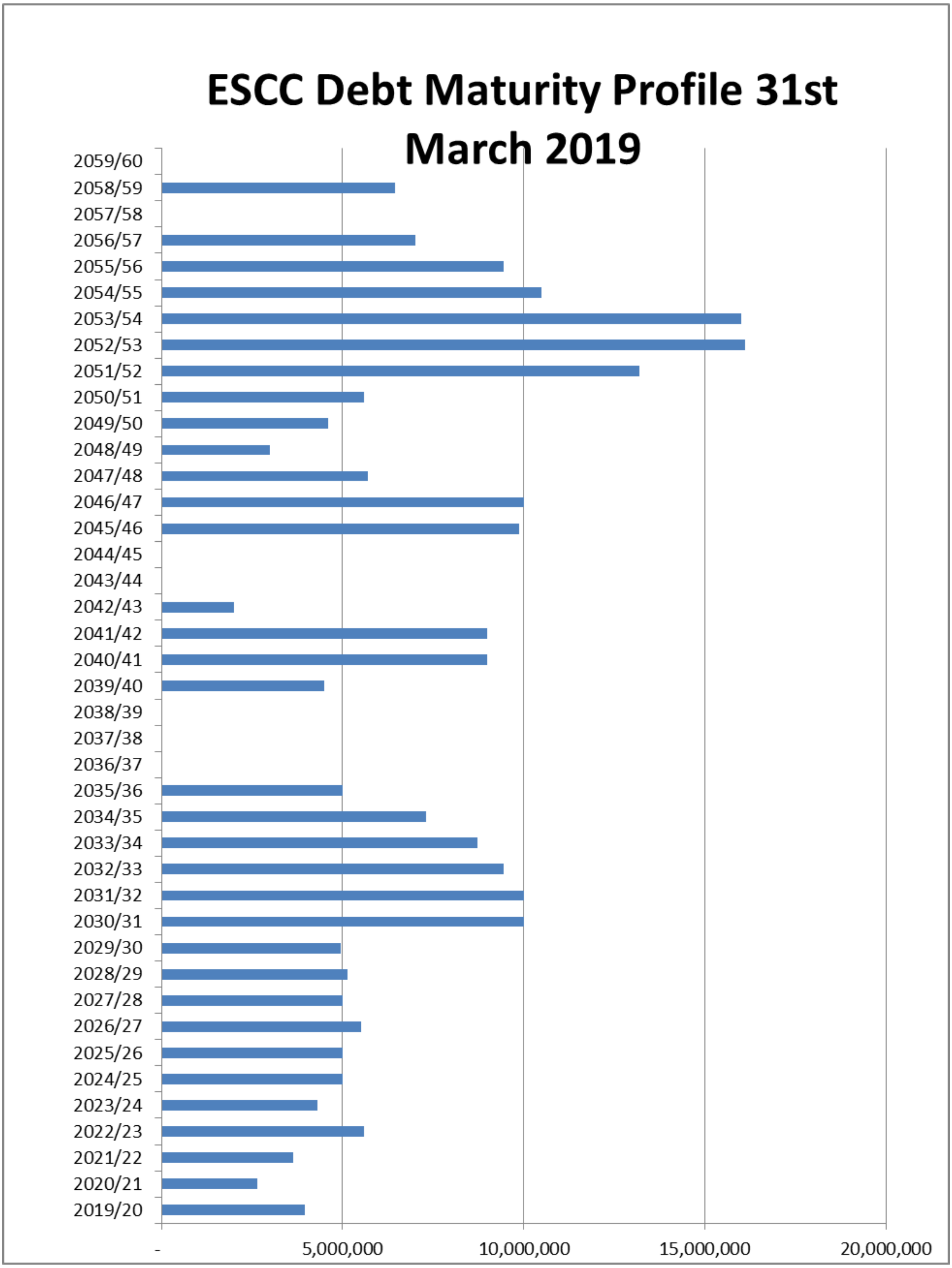
8.5 In view of the variety of different types of capital expenditure incurred by the Council, which is not in all cases capable of being related to an individual asset, asset lives will be assessed on a basis which most reasonably reflects the anticipated period of benefit that arises from the expenditure. Also whatever type of expenditure is involved, it will be grouped together in a manner which reflects the nature of the main component of expenditure. This approach also allows the Council to defer the introduction of an MRP charge for new capital projects/land purchases until the year after the new asset becomes operational rather than in the year borrowing is required to finance the capital spending.

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.

	2018/19 Actual	**2019/20 Estimate**	**2020/21 Estimate**	**2021/22 Estimate**
	£m	**£m**	**£m**	**£m**
Total CFR	**329**	**343**	**371**	**380**
Movement in CFR	-	14	28	9

Annex 1


ESCC Debt Maturity Profile 31st March 2019
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