Report to:	**Cabinet**
Date:	**8 December 2020**
By:	**Chief Operating Officer**
Title of report:	**Treasury Management – Stewardship Report 2019/20**
Purpose of report:	**To present a review of the Council's performance on treasury management for the year 2019/20 and Mid Year review for 2020/21.**

RECOMMENDATION: The Cabinet is recommended to note the Treasury Management performance in 2019/20 incorporating the Mid Year review for the first half of 2020/21.

1. Background

1.1 The annual stewardship report presents the Council's treasury management performance for 2019/20 and Mid Year performance for 2020/21 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 2019/20 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 2020/21 (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 2019/20

3.1 The strategy and the economic conditions prevailing in 2019/20 are set out in Appendix A. 2019/20 remained a challenging environment with concerns over the UK, European and global economies rising especially in the latter part of 2019/20. The global impact of the coronavirus pandemic and the national response and lockdown started to be felt towards the end of 2019/20; it did not have a material impact on the 2019/20 performance.

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

<u>The Treasury Management Strategy</u>

4.1 The strategy for 2019/20, agreed in February 2019, 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 2019/20 strategy Equity Funds were included to broaden the risk profile by reducing liquidity and to include suitable, alternative investment products. The inclusion of an investment product category in the strategy does not automatically result in investments being placed – investments will only be placed following due diligence and consideration of prevailing market conditions.

Short term lending

4.2 The Bank of England (BoE) Base Rate was reduced from 0.75% to 0.25% on 11 March 2020 and again to 0.10% on 19 March 2020 as a measure to support the economy in the early stages of lockdown due to the COVID 19 pandemic.

4.3 The total amount received in short term interest for 2019/20 was £2.3m at an average rate of 1.08%. This was above the average base rates in the same period (0.72%) and above the average returns achieved with peer authorities from treasury advisors (Link Asset Services) investment benchmarking. The Return for 2019/20 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 During 2019/20 a number of longer term local authority investments were placed with the aim of locking in certainty of return. These investments will generate £774,000 in interest receivable in the next two years without compromising credit quality.

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 2019/20.
- The average interest rate of all debt at 31 March 2020 (£239m) was 4.73% (4.77% at 31 March 2019).
- Public Works Loan Board (PWLB) Debt maturing during 2019/20 totalled £3.95m and was at an average rate of 8.17%.
- HM Treasury imposed changes of margins over gilt yields for PWLB rates in 2019-20 without any warning. This took place on 9th October 2019, adding an additional 1% margin over gilts to all PWLB period rates.

Minimum Revenue Provision (MRP)

4.6 Full details of the 2019/20 MRP policy are set out in appendix D.

5. Treasury Management Mid Year Review 2020/21

5.1 The Treasury Management and Annual Investment Strategy for 2020/21 were approved by Full Council on 11 February 2020 and was prepared within the context of the financial challenge being faced by the County Council.

5.2 Events moved quickly in the latter part of 2019/20 with the outbreak of the COVID 19 pandemic, a range of measures were taken to adapt working practices within Treasury Management to facilitate working from home with no business disruption to report.

5.3 Ensuring the County Council had significant liquidity to fund cashflow in the early stages of lockdown was a key priority. On the 1 April 2020 a £10m short term Local Authority loan was taken to cover potential cashflow gaps, the loan was paid back on the 15 May 2020. Cashflow continues to be monitored closely as we move into further uncertainty.

5.4 As in 2019/20 a number of Local Authority investments were placed during the period to secure a fixed rate of return. Deposits placed were at rates between 0.95-1.25% and will outperform bank deposits in the current climate without reducing credit quality.

5.5 The total amount received in short term interest for 6 months to 30 September 2020 was £995k at an average rate of 0.84%. This was above the average base rates in the same period (0.10%) and investment benchmarking with peer authorities.

5.6 No additional PWLB borrowing was undertaken in the period and no cost effective opportunities to restructure debt have taken place. During 2020/21 PWLB to mature totals £2.64m, taking total debt down to £236.6m by 31 March 2021; this historic debt is at an average rate of 8.13%.

5.7 HM Treasury released a consultation with local authorities on possibly further amending margins over PWLB gilt yields; this was to end on 4th June, but that date was subsequently put back to 31 July 2020. It is clear HM Treasury will no longer allow local authorities to borrow money from the PWLB to purchase commercial property if the aim is solely to generate an income stream (assets for yield). The final report is due in the coming year.

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

6.1 The Council is required by the CIPFA Prudential Code to report the actual prudential indicators after the end of each year. There are eight indicators which relate to treasury management and they are set out in Appendix D, 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 0.75% and 1.12%. The key principles of security, liquidity and yield are still relevant. Officers are currently investigating further opportunities within the strategy to increase investment income whilst minimising costs and maintaining security, in a period of significant uncertainty.

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Chief Operating Officer

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<u>BACKGROUND DOCUMENTS</u>

Cabinet 22 January 2019 Treasury Management Strategy for 2019/20
28 January 2020 Treasury Management Strategy for 2020/21

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 2019/20 and the economic factors affecting this strategy

1. Background information

1.1 Full Council approved the annual Treasury Management Strategy report in February 2019, 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 2019/20 was prepared within the context the financial challenge being faced by the County Council over the Medium Term Financial Plan, and the resulting Core Offer that the Council is exploring through the Reconciling Policy, Performance and Resources process for 2019/20. The 2019/20 TMSS seeked to complement the Council's Core Offer by:

- Utilising long term cash balances as effectively as possible by investing in longer term instruments and/or using to fund borrowing to reduce borrowing costs;
- Ensuring the investment portfolio is working hard to maximise income by exploring alternative appropriate investment opportunities during 2019/20;
- Ensuring effective management of the borrowing portfolio by exploring rescheduling opportunities and identifying and exploiting the most cost effective ways of funding the Council's borrowing requirement.

1.4 At the same time, the Treasury Management Policy Statement was agreed as unchanged for 2019/20.

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 2019, 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 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.

Criteria for specified Investments:

Counterparty	Country/ Domicile	Instrument	Min. Credit Criteria/LAS colour band	Max. Amount	Max. maturity period
Debt Management and Deposit Facilities (DMADF)	UK	Term Deposits (TDs)	N/A	unlimited	12 Months
Government Treasury bills	UK	TDs	UK Sovereign Rating	unlimited	12 Months
UK Local Authorities	UK	TDs	UK Sovereign Rating	£60m	12 Months
Banks – part nationalised	UK	▪ TDs ▪ Deposits on Notice ▪ Certificates of Deposit (CDs)	N/A	£60m	12 Months
Banks	UK	▪ TDs ▪ Deposits on Notice ▪ CDs	Blue	£60m	12 Months
			Orange	£60m	12 Months
			Red	£60m	6 Months
			Green	£60m	100 Days
Building Societies	UK	▪ TDs ▪ Deposits on Notice ▪ CDs	Blue	£60m	12 Months
			Orange	£60m	12 Months
			Red	£60m	6 Months
			Green	£60m	100 Days
Individual Money Market Funds (MMF) CNAV and LVNAV	UK/Ireland/ EU domiciled	AAA Rated Money Market Fund Rating	N/A	£60m	Liqiuid
VNAV MMF's and Ultra Short Dated Bond Funds	UK/Ireland/EU domiciled	AAA Rated Bond Fund Fund Rating	N/A	£60m	Liquid

Counterparty	Country/ Domicile	Instrument	Min. Credit Criteria/LAS colour band	Max. Amount	Max. maturity period
Banks – Non-UK	Those with sovereign rating of at least AA+*	▪ TDs ▪ Deposits on Notice ▪ CDs	Blue	£60m	12 Months
			Orange	£60m	12 Months
			Red	£60m	6 Months
			Green	£60m	100 Days

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.

Counterparty	Minimum credit criteria	Maximum investments	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.

5. The economy in 2019/20 – Commentary from Link Asset Services in April 2020.

5.1 Economic growth in 2019 has been very volatile with quarter 1 unexpectedly strong at 0.5%, quarter 2 dire at -0.2%, quarter 3 bouncing back up to +0.5% and quarter 4 flat at 0.0%, +1.1% y/y. 2020 started with optimistic business surveys pointing to an upswing in growth after the ending of political uncertainty as a result of the decisive result of the general election in December settled the Brexit issue. However, the three monthly GDP statistics in January were disappointing, being stuck at 0.0% growth.

5.2 Since then, the whole world has changed as a result of the coronavirus outbreak. It now looks likely that the closedown of whole sections of the economy will result in a fall in GDP of at least 15% in quarter two. What is uncertain, however, is the extent of the damage that will be done to businesses by the end of the lock down period, when the end of the lock down will occur, whether there could be a second wave of the outbreak, how soon a vaccine will be created and then how quickly it can be administered to the population. This leaves huge uncertainties as to how quickly the economy will recover.

5.3 The Monetary Policy Committee raised Bank Rate from 0.5% to 0.75% in August 2018, Brexit uncertainty caused the MPC to sit on its hands and to do nothing until March 2020; at this point it was abundantly clear that the coronavirus outbreak posed a huge threat to the economy of the UK. Two emergency cuts in Bank Rate from 0.75% occurred in March, first to 0.25% and then to 0.10%. These cuts were accompanied by an increase in quantitative easing (QE), essentially the purchases of gilts (mainly) by the Bank of England of £200bn.

5.4 The Government and the Bank were also very concerned to stop people losing their jobs during this lock down period. Accordingly, the Government introduced various schemes to subsidise both employed and self-employed jobs for three months while the country is locked down. It also put in place a raft of other measures to help businesses access loans from their banks, (with the Government providing guarantees to the banks against losses), to tide them over the lock down period when some firms may have little or no income.

5.5 Inflation has posed little concern for the MPC during the last year, being mainly between 1.5 – 2.0%. It is also not going to be an issue for the near future as the world economy will be heading into a recession which is already causing a glut in the supply of oil which has fallen sharply in price. Other prices will also be under downward pressure while wage inflation has also been on a downward path over the last half year and is likely to continue that trend in the current environment. While inflation could even turn negative in the Eurozone, this is currently not likely in the UK.

5.6 Employment had been growing healthily through the last year but it is obviously heading for a big hit in March – April 2020. The good news over the last year is that wage inflation has been significantly higher than CPI inflation which means that consumer real spending power had been increasing and so will have provided support to GDP growth. However, while people cannot leave their homes to do non-food shopping, retail sales will also take a big hit.

5.7 The main issue in 2019 was the repeated battles in the House of Commons to agree on one way forward for the UK over the issue of Brexit. This resulted in the resignation of Teresa May as the leader of the Conservative minority Government and the election of Boris Johnson as the new leader, on a platform of taking the UK out of the EU on 31 October 2019. The House of Commons duly frustrated that renewed effort and so a general election in December settled the matter once and for all by a decisive victory for the Conservative Party: that then enabled the UK to leave the EU on 31 January 2020. However, this still leaves much uncertainty as to whether there will be a reasonable trade deal achieved by the target deadline of the end of 2020. It is also unclear as to whether the coronavirus outbreak may yet impact on this deadline; however, the second and third rounds of negotiations have already had to be cancelled due to the virus.

Appendix B

The Treasury Management activity during the year 2019/20

1. Investment activity interest rates

1.1 Investments were placed with reference to the core balance and cash flow requirements and the outlook for interest rates. Base interest rate was decreased twice in March 2020 to 0.10% the current record low for UK interest rates. The average rate for the year was 0.72%.

1.2 Following consultation, changes to the strategy were made from 2018/19 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.

1.3 The following table below summarises the changes to the 2019/20 strategy from those approved since 2017/18. The inclusion of an investment product category in the strategy does not automatically result in investments being placed.

Investment options	2017/18	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	✗	✗	✓

The primary principle governing the Council's investment criteria is the security of its investments, although the return on the investment is also a key consideration. After this main principle, the Council will ensure that:

- It maintains a policy covering both the categories of investment types it will invest in and the criteria for choosing investment counterparties with adequate security, and monitoring their security;
- It has sufficient liquidity in its investments.

1.4 The total amount received in short term interest for 2019/20 was £2.3m at an average rate of 1.08%. This was above the average of base rates in the same period (0.72%) 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.

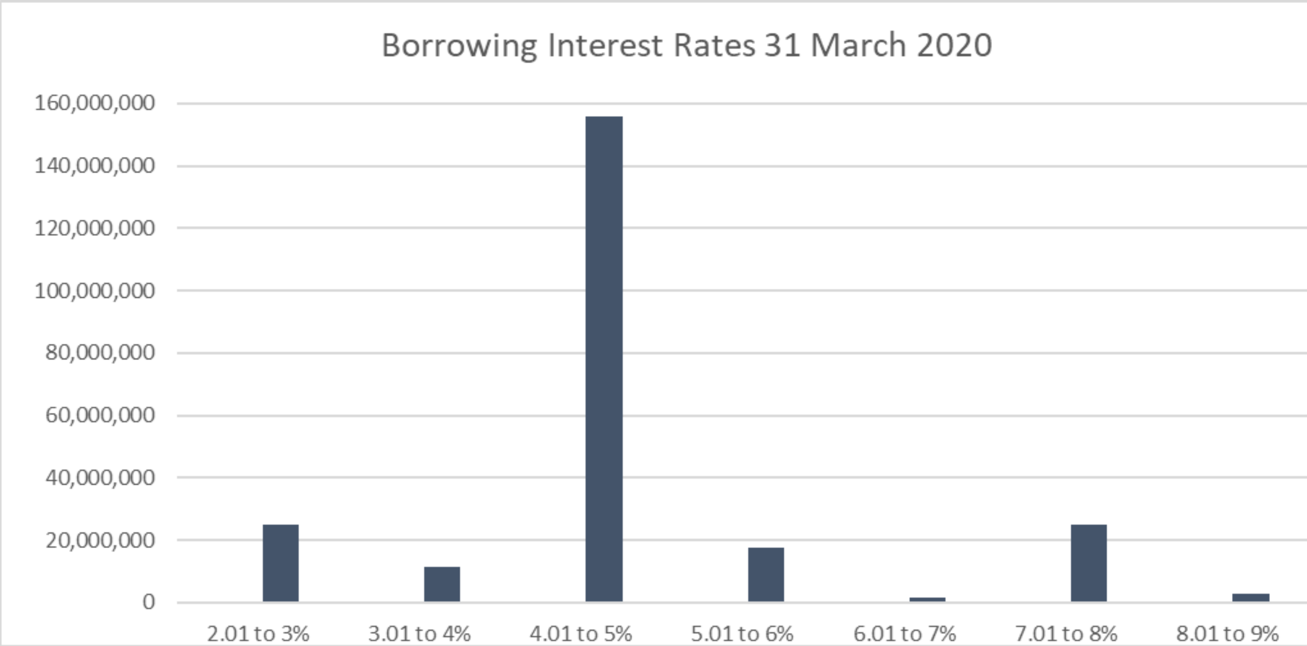
2. Long term borrowing

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 2019/20 £3.95m of PWLB debt matured at a coupon rate of 8.17%. 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 2020 of £239.2m was 4.73%. 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 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 range of interest rates payable in all of the loans is illustrated in the graph below:



3. Short term borrowing

3.1 Overnight borrowing was undertaken on two separate occasions during 2019/20 to cover temporary overdraft situations.

4. Treasury Management Advisers

4.1 The Strategy for 2019/20 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 – 2020/21

1. Background

1.1 The Treasury Management and Annual Investment Strategy for 2020/21 were approved by the Cabinet 22 January 2020. The 2020/21 strategy broadened the approved instruments to improve yield and diversify the investment portfolio. Changes to the strategy are summarised below.

Investment options	2017/18	2018/19	2019/20	2020/21
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 (Including Short Dated 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 The Bank of England's Monetary Policy Committee have held interest rates at 0.10% over the period. Our Treasury Advisors Link Asset Services are forecasting a low interest rate environment for the next 2 years and beyond.

2.2 During the first half year investments have been held in money market funds, bank notice accounts, 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.

2.3 Measures have been undertaken to ensure that levels of liquidity are available during the last 6 months but also opportunities explored to protect investment returns into the current year and beyond. Several local authority investments were placed upto a 2 year period securing a fixed rate of return between 0.95-1.25% within a low credit risk parameter.

2.4 The average investment balance to September 2020 was £235m and generated investment income of £995k. The forecast for 2020/21 is £1.7m.

2.5 A short term loan was arranged on the 1st April 2020 with another local authority to cover potential gaps in the Council's cashflow, the £10m loan was paid back on maturity 15th May 2020 and was at a rate of 0.15%. Future short-term borrowing in the current year is not forecasted but remains an option to cover temporary cashflow requirements.

2.6 The level of Council long-term debt at 30 September 2020 was £237.9m with a loan totalling £1.3m maturing with the PWLB in the next 6 months to 31st March 2021. The forecast for interest paid on long-term debt in 2020/21 is approximately £11.15m and is within the budgeted provision.

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

3. Treasury Management Strategy

3.1 The Council approved the 2020/21 treasury management strategy at its meeting on 22 January 2020. 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 2020/21 investment strategy continues with officers seeking new opportunities to invest long-term cash in suitable longer term instruments in order to assist in delivering treasury savings by increasing investment income. Modelling of the Council's use or reserves and planned capital programme has identified £5-10m of balances that could be invested for a longer duration (for approximately 3 years). An options appraisal review was undertaken during 2019/20 to identify investment options which matched the three year time horizon. Short Dated Bond Funds and Multi Asset Funds have been identified as suitable instruments that match the Council's risk appetite and investment time horizon.

3.3 At its meeting of 15 October 2019, Full Council declared a Climate Emergency (Item 37), and discussed the Environmental, Social and Governance (ESG) considerations for the East Sussex Pension Fund (Item 34). Treasury Officers have been exploring ways in which the Council's cash balances can be utilised to support the Council's commitment to tackle climate change. As a result, consideration of ESG factors has been built into the 2020/21 Annual Investment Strategy.

3.4 The Chief Finance Officer is pleased to report that all treasury management activity undertaken from April 2020 to September 2020 period complied with the approved strategy, the CIPFA Code of Practice, and the relevant legislative provisions.

4. Economic Review (provided by Link Asset Services, September 2020)

4.1 The coronavirus outbreak has done huge economic damage to the UK and economies around the world.

4.2 As expected, the Bank of England's Monetary Policy Committee kept Bank Rate unchanged on 6th August (and subsequently 16th September). It also kept unchanged the level of quantitative easing at £745bn. Its forecasts were optimistic in terms of three areas:

- The fall in GDP in the first half of 2020 was revised from 28% to 23% (subsequently revised to -21.8%). This is still one of the largest falls in output of any developed nation. However, it is only to be expected as the UK economy is heavily skewed towards consumer-facing services – an area which was particularly vulnerable to being damaged by lockdown.
- The peak in the unemployment rate was revised down from 9% in Q2 to 7½% by Q4 2020.
- It forecast that there would be excess demand in the economy by Q3 2022 causing CPI inflation to rise above the 2% target in Q3 2022, (based on market interest rate expectations for a further loosening in policy). Nevertheless, even if the Bank were to leave policy unchanged, inflation was still projected to be above 2% in 2023.

4.3 It also squashed any idea of using negative interest rates, at least in the next six months or so. It suggested that while negative rates can work in some circumstances, it would be "less effective as a tool to stimulate the economy" at this time when banks are worried about future loan losses. It also has "other instruments available", including QE and the use of forward guidance.

4.4 The MPC expected the £300bn of quantitative easing purchases announced between its March and June meetings to continue until the "turn of the year". This implies that the pace of purchases will slow further to about £4bn a week, down from £14bn a week at the height of the crisis and £7bn more recently.

4.5 In conclusion, this would indicate that the Bank could now just sit on its hands as the economy was recovering better than expected. However, the MPC acknowledged that the "medium-term projections were a less informative guide than usual" and the minutes had multiple references to downside risks, which were judged to persist both in the short and medium term. One has only to look at the way in which second waves of the virus are now impacting many countries including Britain, to see the dangers. However, rather than a national lockdown, as in March, any spikes in virus infections are now likely to be dealt with by localised measures and this should limit the amount of economic damage caused. In addition, Brexit uncertainties ahead of the year-end deadline are likely to be a drag on recovery. The wind down of the initial generous furlough scheme through to the end of October is another development that could cause the Bank to review the need for more support for the economy later in the year. Admittedly, the Chancellor announced in late September a second six month package from 1 November of government support for jobs whereby it will pay up to 22% of the costs of retaining an employee working a minimum of one third of their normal hours. There was further help for the self-employed, freelancers and the hospitality industry. However, this is a much less generous scheme than the furlough package and will inevitably mean there will be further job losses from the 11% of the workforce still on furlough in mid September.

4.6 Overall, the pace of recovery is not expected to be in the form of a rapid V shape, but a more elongated and prolonged one after a sharp recovery in June through to August which left the economy 11.7% smaller than in February. The last three months of 2020 are now likely to show no growth as consumers will probably remain cautious in spending and uncertainty over the outcome of the UK/EU trade negotiations concluding at the end of the year will also be a headwind. If the Bank felt it did need to provide further support to recovery, then it is likely that the tool of choice would be more QE

5.0 Link Asset Services interest rate forecasts

5.1 As shown in the forecast table below, no increase in Bank Rate is expected within the forecast horizon ending on 31st March 2023 as economic recovery is expected to be only gradual and, therefore, prolonged.

5.2 Forecasts for average investment earnings beyond December 2021 will be heavily dependent on economic and political developments.

Link Group Interest Rate View 11.8.20	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	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 month average earnings	0.05	0.05	0.05	0.05	0.05	0.05	-	-	-	-	-
6 month average earnings	0.10	0.10	0.10	0.10	0.10	0.10	-	-	-	-	-
12 month average earnings	0.15	0.15	0.15	0.15	0.15	0.15	-	-	-	-	-
5yr PWLB Rate	1.90	1.90	2.00	2.00	2.00	2.00	2.00	2.10	2.10	2.10	2.10
10yr PWLB Rate	2.10	2.10	2.10	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.30
25yr PWLB Rate	2.50	2.50	2.50	2.50	2.60	2.60	2.60	2.70	2.70	2.70	2.70
50yr PWLB Rate	2.30	2.30	2.30	2.30	2.40	2.40	2.40	2.50	2.50	2.50	2.50

6. Borrowing advice:

6.1 As the interest forecast table for PWLB certainty rates, (gilts plus 180bps), above shows, there is likely to be little upward movement in PWLB rates over the next two years as it will take economies, including the UK, a prolonged period to recover all the momentum they have lost in the sharp recession caused during the coronavirus shut down period. Inflation is also likely to be very low during this period and could even turn negative in some major western economies during 2020/21.

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 set out the estimate and projected Capital financing requirement and long-term borrowing in 2019/20

	Capital Financing Requirement	**2019/20 Estimate**	**2019/20 Actual**
		£m	**£m**
	Capital Financing Requirement at 1 April 2019	**335**	**329**
add	Financing of new assets	14	24
add	Long Term Loans	-	-
less	Provision for repayment of debt	(6)	(11)
	Capital Financing Requirement at 31 March 2020	**343**	**342**
add	Short Term Borrowing Provision	10	
	Operational Boundary	**353**	
add	Short Term Borrowing Provision	20	
	Authorised Limit	**373**	

	Actual Borrowing	**2019/20 Actual**
		£m
	Long Term Borrowing at 1 April 2019	**243**
less	Loan redemptions	(4)
add	New Borrowing	-
	Long Term Borrowing at 31 March 2020	**239**

2.2 The Capital Financing Requirement includes PFI Schemes and Finance Leases totalling £81m, excluding these results in an underlying need to borrow of £261m.

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 2020 of £239m is under the Operational boundary and Authorised limit set for 2019/20. 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 2019/20. 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.

	2019/20	**2020/21**	**2021/20**
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 2019/20			
	Lower	**Upper**	**Actual 2019/20**
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%	21%
20 years and within 30 years	0%	80%	24%
30 years and within 40 years	0%	80%	35%
40 years and above	0%	80%	0%

3.2 The Council has not exceeded the limits set in 2019/20. 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 will be been defined with the assistance of Link Asset Services. However, due to the increase in PWLB margins over gilt yields in October 2019, and the subsequent consultation on these margins by HM Treasury - which ended on 31 July 2020 - the Council has refrained from undertaking new long-term PWLB borrowing for the present.

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 2018, 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 2019/20

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	194	1.08%	0.33%
May	204	1.04%	0.29%
June	199	1.05%	0.30%
July	205	1.07%	0.32%
August	202	1.07%	0.32%
September	188	1.06%	0.31%
October	198	1.06%	0.31%
November	192	1.08%	0.33%
December	189	1.10%	0.35%
January	195	1.12%	0.37%
February	177	1.11%	0.36%
March	186	1.10%	0.75%*
Total for 2019/20	**2,329**	**1.08%**	**0.36%**

*Average base rate in March 2020 0.35% (all other months 0.75%) 0.72% for 2019/20.

7.2 The total amount received in short term interest for the year was £2.3m at an average rate of 1.08%. This was above the average of base rates in the same period (0.72%) 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 2019/20 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 2019/20 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.

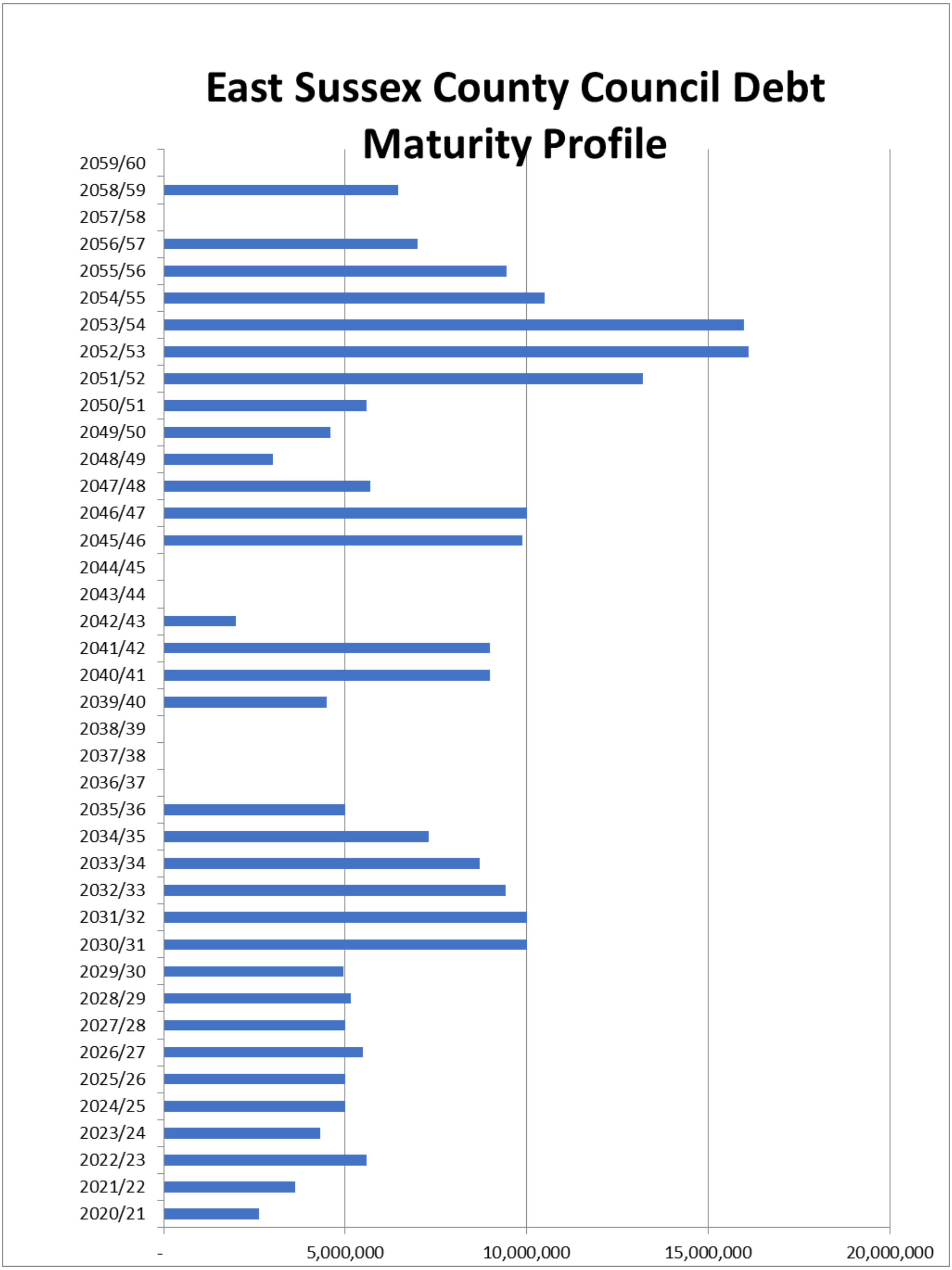
8.5 In view of the variety of different types of capital expenditure incurred by the Council, which is not in all cases capable of being related to an individual asset, asset lives will be assessed on a basis which most reasonably reflects the anticipated period of benefit that arises from the expenditure. 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.

	2019/20 Actual	**2020/21 Estimate**	**2021/22 Estimate**	**2022/23 Estimate**
	£m	**£m**	**£m**	**£m**
Total CFR	**342**	**395**	**410**	**421**
Movement in CFR	-	53	15	11

Annex 1


East Sussex County Council Debt Maturity Profile
2059/60
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2057/58
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2051/52
2050/51
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