## Treasury Management Annual Report 2016/17

### Background

**1** County Council is required by regulations issued under the Local Government Act 2003 to review an annual treasury management report detailing borrowing and investment activity (as compared with the approved Treasury Management Strategy) and actual prudential and treasury indicators for 2016/*17* (as contained within the approved Budget Report). The Treasury Management Annual Report **set out at the Appendix** therefore meets the requirements of both the Chartered Institute of Public Finance and Accountancy (CIPFA) 'Code of Practice on Treasury Management' (the Code) and the CIPFA 'Prudential Code for Capital Finance in Local Authorities' (the Prudential Code).

**2** In addition, and in accordance with governance arrangements approved by County Council in February 2014, the Performance and Finance Select Committee received a mid-year review of treasury management activity for scrutiny (December 2016) and the Regulation, Audit and Accounts Committee has received quarterly treasury management update reports on compliance against the approved Treasury Management Strategy (September 2016, November 2016, March 2017 and June 2017).

### Discussion

**3** The County Council's risk procedures regarding its treasury management activities focus on the unpredictability of financial markets and implementing restrictions to minimise these risks. Financial risks are minimised through compliance with the annual Treasury Management Strategy, which incorporates the prudential and treasury indicators, approved for 2016/17 by County Council in February 2016 (subsequently amended by the 2017/18 Treasury Management Strategy approved in February 2017).

**4** During 2016/17 the County Council continued to be a mainly temporary lender due to its level of reserves and the timing of grant and precept income ahead of spending, so had significant cash surpluses. The Council complied with all of the statutory and regulatory requirements which require officers to identify and where possible quantify the levels of risk associated with its treasury management activities.

**5** The Cabinet Member for Finance and Resources confirms that:

- **Borrowing**: Given the differential between the cost of new Public Works Loan Board (PWLB) borrowing against the return generated on the County Council's investments, the use of internal resources in lieu of external borrowing continued to be the most cost effective means of funding 2016/17 capital expenditure (core programme and income generating initiatives). £7m (plus interest) was however repaid to the PWLB as per the terms and conditions of the £70m borrowing taken during April 2011.

- The Treasury Management Strategy allows occasional short-term borrowing to cover day-to-day cash flow shortages. On three occasions during 2016/17 the County Council's overdrawn position of its main bank account held with Lloyds exceeded £1m which in accordance with the Treasury Management Strategy represented short-term borrowing for a period of one working day. On all other occasions daily overdrawn balances within the County Council's main bank account were met from balances held in the Council's instant access accounts and short-term Money Market Funds.
- At 31 March 2017 the County Council's external borrowing, excluding PFI schemes and finance leases, was £402.9m (£409.9m at 31 March 2016). Total interest payable during 2016/17 was £18.3m at an average rate of 4.53%.
- **Investment**: Security of capital remained the main investment objective. This continued to be maintained by following the County Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2016/17. At 31 March 2017 the Council's investments totalled £258m (£235.3m at 31 March 2016). Gross investment interest received during 2016/17 was £1.9m, representing a return of 0.67% on an average investment portfolio of £282m.

**WSCC Average Investment Portfolio**

| | 2015/16 | | 2016/17 | |
|---|---|---|---|---|
| | £'m | % | £'m | % |
| UK Banks: Unsecured Deposits | 58.5 | 19.7 | 63.6 | 22.5 |
| UK Banks: Secured Deposits | 12.3 | 4.1 | 19.9 | 7.1 |
| Non-UK Banks: Unsecured | 42.7 | 14.4 | 58.0 | 20.6 |
| Non-Bank Corporates | 17.4 | 5.8 | 6.8 | 2.4 |
| Local Authority | 55.8 | 18.8 | 33.4 | 11.8 |
| Housing Associations | 1.0 | 0.3 | 0.7 | 0.3 |
| Money Market Funds | 72.9 | 24.6 | 78.5 | 27.8 |
| Externally Managed Pooled Funds | 36.2 | 12.2 | 20.9 | 7.4 |
| UK Municipal Bond Agency | 0.2 | 0.1 | 0.2 | 0.1 |
| **Total** | **297.0** | **100.0** | **282.0** | **100.0** |

**6** The Cabinet Member for Finance and Resources confirms that there was one breach of the approved investment strategy during the period, which occurred at the end of the first quarter and was fully discussed by the Treasury Management Panel and the Regulation, Audit and Accounts Committee at their September meetings in accordance with approved governance (compliance) arrangements:

- Following the repayment by another local authority incorrectly into the County Council's old HSBC bank account on investment maturity (£10.3m) together with an existing investment deposited within a three-month HSBC notice account (£15m), the total amount deposited with HSBC on an unsecured basis exceeded the approved £15m monetary limit for one working day only (Paragraphs 4.9 to 4.11).

**Recommended**

That the Treasury Management Annual Report for 2016/17, as set out in the Appendix, be noted.

**Jeremy Hunt**
Cabinet Member for Finance and Resources

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**Background Papers**

None

(see paragraph 1, page 95)

## Treasury Management Annual Report (2016/17)

### 1. Introduction

1.1 Treasury management is defined as: "The management of the Council's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

1.2 Overall responsibility for treasury management remains with the County Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives.

1.3 The County Council's approval for treasury management is governed by the following documents:

- CIPFA's "Code of Practice on Treasury Management" (the Code).
- CIPFA's "Prudential Code for Capital Finance in Local Authorities" (the Prudential Code).
- Treasury Management Strategy Statement (TMSS) including Prudential and Treasury Indicators: Approved by County Council annually at the February budget meeting.
- Treasury Management Practices (TMPs): A detailed set of procedures that ensure compliance with the policy.

1.4 The Council's Treasury Management Strategy for 2016/17, originally approved by County Council on 19 February 2016, can be accessed on: http://www2.westsussex.gov.uk/ds/cttee/cc/cc190216i5c.pdf.

1.5 The CIPFA Treasury Management Code of Practice requires that an annual report should be made on treasury management activities, and the associated monitoring and control of risk, for the previous financial year.

1.6 The Council has substantial amounts of investments and borrowings and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. This annual report therefore details both treasury management activities during 2016/17 together with compliance against the approved Treasury Management Strategy; including investment strategy changes included within the 2017/18 Treasury Management Strategy approved by County Council in February 2017 and implemented with immediate effect during the remainder of 2016/17.

1.7 The Treasury Management Practices (TMPs) are reviewed and updated where required in collaboration with specialist treasury management advisors, the next review being scheduled during the summer of 2017. The TMPs continue to be used as a working document by the Council's Treasury Management Team covering specific areas of risk management

including credit and counterparty risk, liquidity risk, interest rate risk and the detailed procedures for investing surplus cash.

## 2. Economic and Market Background

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

2.2 In the second half of 2016 the UK economy confounded the Bank's pessimistic forecasts of August. After disappointing first quarter GDP growth of only 0.2% the three subsequent quarters of 2016 came in at 0.6%, 0.5% and 0.7% respectively to produce an annual growth for 2016 of 1.8% (as compared to 2015). The rate of UK growth in 2016 was one of the best performers of any of the G7 countries and as a consequence this meant that the MPC did not cut the UK Bank Rate again after August 2016. Since August however, UK Consumer Price Index (CPI) inflation has risen rapidly due to the effects of the sharp devaluation of sterling after the referendum.

2.3 By the end of March 2017, sterling was 17% down against the dollar but had not fallen as far against the euro. In February and March 2017 the latest CPI inflation figure had risen to 2.3%, above the MPC's inflation target of 2%. However the MPC's view remained that it would look through near term supply side driven inflation caused by sterling's devaluation, despite forecasting that inflation would reach nearly 3% during 2017 and 2018. This outlook however is dependent on domestically generated inflation (including wage inflation) continuing to remain subdued despite the fact that UK unemployment is at historically low levels and is on a downward trend. Market expectations for the first increase in the UK Bank Rate moved forward to the third quarter of 2018 in response to inflation concerns.

2.4 In Equity markets, the result of the Brexit referendum and the consequent devaluation of sterling boosted the shares of many FTSE 100 companies which had major earnings which were not denominated in sterling. The overall trend since then has been steeply upwards and received further

momentum after Donald Trump was elected President given the promise of a major fiscal stimulus to boost the US economy and growth rate.

2.5 **United States**: Quarterly growth in the US whilst being very volatile during 2016 did display strong performance since mid-2016 (overall growth in 2016 was 1.6%). This together with rising inflation prompted the Fed into raising rates in December 2016 and March 2017. The US is the first major western country to start on a progressive upswing in rates.

2.6 **Europe**: The EU is furthest away from an upswing in rates; the European Central Bank (ECB) has cut rates into negative territory, provided huge tranches of cheap financing and been doing major quantitative easing purchases of debt during 2016/17 in order to boost growth from consistently weak levels and to get inflation up from near zero towards its target of 2%. These purchases have resulted in depressed bond yields in the EU but towards the end of 2016 yields rose, probably due at least in part to rising political concerns around the positive prospects for populist parties and impending general elections in 2017 in the Netherlands, France and Germany. The action taken by the ECB has resulted in economic growth improving significantly in the Eurozone to an overall figure of 1.7% for 2016, with Germany achieving a rate of 1.9% as the fastest growing G7 country.

2.7 **China and emerging market counties**: At the start of 2016 there were considerable fears that China's economic growth could be heading towards a hard landing, which could then destabilise some emerging market countries particularly exposed to a Chinese economic slowdown and/or to the effects of a major reduction in revenue from low oil prices. These fears have largely subsided and oil prices have partially recovered so overall, world growth prospects have improved during the year.

2.8 **Investment Rates**: Bank deposit rates that were already at depressed levels at the start of 2016/17 fell even further following Brexit, the subsequent cut to the UK Bank Rate and the tranche of cheap financing made available to the banking sector by the Bank of England. Whilst deposit rates made a weak recovery towards the end of 2016 they fell to fresh lows in March 2017, as evidenced by the London Interbank Bid Rates (LIBID) in the table below:

| Date | Bank Rate | O/N LIBID | 7-day LIBID | 1-month LIBID | 3-month LIBID | 6-month LIBID | 1-year LIBID |
|---|---|---|---|---|---|---|---|
| 01/04/2016 | 0.50 | 0.36 | 0.36 | 0.39 | 0.46 | 0.61 | 0.88 |
| 30/04/2016 | 0.50 | 0.36 | 0.36 | 0.38 | 0.47 | 0.62 | 0.90 |
| 31/05/2016 | 0.50 | 0.35 | 0.37 | 0.39 | 0.46 | 0.61 | 0.89 |
| 30/06/2016 | 0.50 | 0.35 | 0.36 | 0.39 | 0.43 | 0.55 | 0.80 |
| 31/07/2016 | 0.50 | 0.35 | 0.34 | 0.31 | 0.37 | 0.46 | 0.68 |
| 31/08/2016 | 0.25 | 0.10 | 0.12 | 0.15 | 0.26 | 0.40 | 0.61 |
| 30/09/2016 | 0.25 | 0.10 | 0.12 | 0.14 | 0.26 | 0.41 | 0.63 |
| 31/10/2016 | 0.25 | 0.10 | 0.12 | 0.14 | 0.28 | 0.44 | 0.69 |
| 30/11/2016 | 0.25 | 0.10 | 0.13 | 0.14 | 0.26 | 0.43 | 0.67 |
| 31/12/2016 | 0.25 | 0.09 | 0.11 | 0.13 | 0.24 | 0.41 | 0.65 |
| 31/01/2017 | 0.25 | 0.10 | 0.12 | 0.14 | 0.23 | 0.41 | 0.65 |
| 28/02/2017 | 0.25 | 0.10 | 0.12 | 0.14 | 0.23 | 0.39 | 0.61 |

| Date | Bank Rate | O/N LIBID | 7-day LIBID | 1-month LIBID | 3-month LIBID | 6-month LIBID | 1-year LIBID |
|---|---|---|---|---|---|---|---|
| 31/03/2017 | 0.25 | 0.10 | 0.11 | 0.13 | 0.21 | 0.37 | 0.59 |
| | | | | | | | |
| Minimum | 0.25 | 0.09 | 0.11 | 0.13 | 0.21 | 0.37 | 0.59 |
| **Average** | **0.34** | **0.19** | **0.20** | **0.22** | **0.32** | **0.46** | **0.70** |
| Maximum | 0.50 | 0.36 | 0.37 | 0.39 | 0.47 | 0.62 | 0.90 |
| Spread | 0.25 | 0.27 | 0.26 | 0.26 | 0.26 | 0.25 | 0.31 |

2.9 **Borrowing Rates**: After Brexit and the subsequent UK Bank Rate cut, Public Works Loan Board (PWLB) borrowing rates continued their downward impetus which had been evident throughout the first quarter of 2016/17 through to the end of August 2016. PWLB rates then staged a partial recovery through to December before easing back again by the end of March 2017; as evidenced in the table below (new PWLB maturity loan rates adjusted for 0.20% certainty rate discount available to UK local authorities):

| Date | Bank Rate | 1-Year PWLB | 5-Year PWLB | 10-Year PWLB | 20-Year PWLB | 25-Year PWLB | 50-Year PWLB |
|---|---|---|---|---|---|---|---|
| 01/04/2016 | 0.50 | 1.13 | 1.62 | 2.31 | 3.04 | 3.14 | 2.95 |
| 30/04/2016 | 0.50 | 1.17 | 1.75 | 2.45 | 3.13 | 3.22 | 3.01 |
| 31/05/2016 | 0.50 | 1.16 | 1.73 | 2.36 | 3.02 | 3.09 | 2.87 |
| 30/06/2016 | 0.50 | 0.95 | 1.26 | 1.86 | 2.55 | 2.63 | 2.33 |
| 31/07/2016 | 0.50 | 0.87 | 1.11 | 1.64 | 2.37 | 2.47 | 2.24 |
| 31/08/2016 | 0.25 | 0.89 | 1.03 | 1.45 | 2.02 | 2.11 | 1.88 |
| 30/09/2016 | 0.25 | 0.83 | 1.01 | 1.52 | 2.18 | 2.27 | 2.10 |
| 31/10/2016 | 0.25 | 0.96 | 1.44 | 2.07 | 2.65 | 2.71 | 2.49 |
| 30/11/2016 | 0.25 | 0.81 | 1.46 | 2.23 | 2.80 | 2.84 | 2.57 |
| 31/12/2016 | 0.25 | 0.77 | 1.35 | 2.08 | 2.66 | 2.71 | 2.46 |
| 31/01/2017 | 0.25 | 0.88 | 1.54 | 2.30 | 2.87 | 2.91 | 2.68 |
| 28/02/2017 | 0.25 | 0.80 | 1.24 | 1.94 | 2.61 | 2.67 | 2.44 |
| 31/03/2017 | 0.25 | 0.83 | 1.24 | 1.91 | 2.54 | 2.60 | 2.34 |
| | | | | | | | |
| Minimum | 0.25 | 0.76 | 0.95 | 1.42 | 2.00 | 2.08 | 1.87 |
| **Average** | **0.34** | **0.93** | **1.36** | **2.01** | **2.65** | **2.72** | **2.49** |
| Maximum | 0.50 | 1.20 | 1.80 | 2.51 | 3.20 | 3.28 | 3.08 |
| Spread | 0.25 | 0.44 | 0.85 | 1.09 | 1.20 | 1.20 | 1.21 |

2.10 **Counterparty Update**: Following the Brexit vote, various indicators of credit risk reacted negatively to the referendum result with UK bank credit default swaps (CDS) prices experiencing a modest rise, but bank share prices falling sharply (on average by 20%) with UK-focused banks experiencing the largest falls. Non-UK bank share prices were not immune, although the fall in their share prices was less pronounced.

2.11 All three major rating agencies (Fitch, Moody's and Standard & Poor's) took action on the UK sovereign credit rating on the expectation of a more challenging operating environment arising from the 'leave' outcome. Fitch downgraded the UK's sovereign rating to AA (from AA+). Standard & Poor's downgraded its corresponding rating to AA (from AAA) and took similar rating actions on rail company bonds guaranteed by the UK Government. Additionally Standard & Poor's downgraded 21 UK social housing providers and revised the outlook on Places for People Group to negative, affirmed the short and long-term ratings of seven UK banks and building societies, but revising their outlooks downwards *(Barclays,*

*Clydesdale, HSBC, Lloyds Banking Group, Nationwide, Santander UK and the Royal Bank of Scotland)* and downgraded the long-term rating of the European Union to AA (from AA+) on the view that the referendum result lowered the union's fiscal flexibility and weakened its political cohesion. Moody's placed a negative outlook on the UK and revised the outlook of nine UK banks and building societies to negative.

2.12 There was no immediate change from the Council's treasury management advisor following the outcome of the referendum regarding credit advice on UK banks and building societies included on the Council's approved counterparty list. Therefore whilst there was no change to the Council's investment strategy regarding unsecured bank deposits, the Council's assumed level for the long-term ratings of unrated UK local authorities was revised down to AA- from AA (i.e. one notch below the UK sovereign rating).

2.13 At the end of November 2016 (and following the results of the European Banking Authority stress tests in July 2016) the Bank of England released the results of its annual stress testing on the UK banking system. Seven financial institutions were tested including Barclays, HSBC, Lloyds Banking Group, Nationwide, the Royal Bank of Scotland (RBS), Santander UK and Standard Chartered. The 2016 tests were conducted under the Bank of England's new approach to stress testing which examined the resilience of the banking system and the capital adequacy of individual financial institutions against a more severe stress than the previous 2014 and 2015 scenarios. Whilst all seven institutions analysed passed the overall test RBS, Barclays and Standard Chartered did fall short on some individual measures. Neither Barclays nor Standard Chartered were required to submit revised plans due to actions already taken by both banks to bolster capital throughout 2016. However, based on the outcome of the tests, RBS updated its capital plans to incorporate further capital strengthening actions which were then accepted by the Prudential Regulation Authority (PRA) Board.

2.14 Other credit rating actions taken by Fitch, Moody's and Standard & Poor's against individual financial institutions approved for Council investment were reported throughout 2016/17 to the Treasury Management Panel (at regular Panel meetings) and to the Regulation, Audit and Accounts Committee (within quarterly treasury management compliance reports).

## 3. Treasury Management Advisors

3.1 Following procurement for Treasury Management Advisors undertaken during the third quarter of 2016/17, Capita Asset Services (formerly Sector Treasury Services) was appointed as the Council's new advisor. Capita Asset Services was appointed on the basis that they would offer additional services to the benefit of the Council's treasury management strategies and deliver a cost saving over the contract period through lower advisory fees. The new contract commenced on 1 November 2016 and is subject to triennial reviews, with the next review scheduled during 2019/20.

## 4. Treasury Management Strategy (2016/17)

4.1 The County Council's treasury activities expose it to a variety of financial risks, the key risks are:

- **Credit Risk**: The possibility that other parties might fail to pay amounts due to the Council;
- **Liquidity Risk**: The possibility that the Council might not have funds available to meet its commitments to make payments;
- **Re-financing Risk**: The possibility that the Council might be requiring to renew a financial instrument on maturity at disadvantageous interest rates or terms;
- **Market Risk**: The possibility that financial loss might arise for the Council as a result of changes in such measures as inflation rates, commercial property prices, stock market movements or foreign currency exchange rates.

4.2 The Council's overall risk management programme focuses on the unpredictability of financial markets, and seeks to minimise potential adverse effects on resources available to fund services. The procedures for risk management are set out through a legal framework based on the Local Government Act 2003 and the associated regulations (including CIPFA Codes of Practice). The Department for Communities and Local Government (DCLG) "Investment Guidance" emphasises the need to focus on security and liquidity, rather than yield. It also recommends that treasury strategies include details of assessing credit risk, reasons for borrowing in advance of need and the use of treasury management advisors.

4.3 Financial risks were minimised through the annual Treasury Management Strategy, which incorporates the Prudential and Treasury Indicators (**set out at the Annex**) and was approved for 2016/17 by County Council in February 2016. The key issues within the strategy were:

- The Authorised Borrowing Limit was set at £615.4m. This is the maximum limit of external borrowings and other long-term liabilities;
- The Operational Borrowing Limit was expected to be £575.4m. This is the expected level of actual debt and other long-term liabilities during the year;
- The underlying need to borrow as measured by the Capital Financing Requirement (CFR) was estimated at £615.6m;
- The maximum borrowing exposure to fixed and variable interest rates was set at 100% and 25% respectively, based on the Council's gross borrowing;
- The maximum amount that could be invested for greater than one year was set at £100m (subsequently reduced to £45m following approval of the 2017/18 Treasury Management Strategy).

4.4 The expectation for interest rates within the originally approved Treasury Management Strategy was for the UK Bank Rate to remain low, but to start to gradually rise from August 2016 and average around 0.70%

throughout 2016/17. At the same time forecast rises in medium to longer term fixed rate borrowing and the resulting 'cost of carry' implications of taking on new long-term debt (whereby the proceeds of external borrowing are temporarily invested in lower yielding investments) meant that short-term borrowing (including internal borrowing) was approved as the most cost effective approach over the period. A cautious approach was maintained regarding internally managed investments, whereby investments continued to be dominated by low counterparty risk considerations resulting in relatively low returns throughout the period.

4.5 **Credit Risk**: Throughout 2016/17 the Council complied with all of the relevant statutory and regulatory requirements which require officers to identify and where possible quantify the levels of risk associated with its treasury management activities. Additionally the Council confirms that it has complied with the requirement under the Code to give prior scrutiny to treasury management reports by the Treasury Management Panel before submission to County Council, the Performance and Finance Select Committee and the Regulation, Audit and Accounts Committee.

4.6 Credit and counterparty risk was managed through the Council's "Annual Investment Strategy" (as contained within the approved Treasury Management Strategy) which limits the monetary amount and time duration of deposits arranged with individual counterparties. Additionally the strategy required that investments are not made with organisations unless they met identified minimum credit criteria; in particular counterparty credit quality was assessed and monitored with reference to credit ratings, credit default swap prices, financial statements, information on potential government support and general media alerts.

4.7 In accordance with DCLG Investment Guidance the security and liquidity of the Council's investments remained primary investment objectives, such risks being mitigated by following the approved counterparty policy as set out in the Treasury Management Strategy Statement for 2016/17. The credit risk associated with making unsecured deposits with financial institutions (including banks and building societies) remained elevated relative to other investment options available to the Council, due to the bail-in regimes now implemented by many countries. Where possible officers continued to make use of secured bank investments options (covered bonds) or diversified investment alternatives (non-bank investments including corporates, local authorities and externally managed pooled funds) as a way of mitigating the increased risks of bail-in legislation.

4.8 The Council defined 'high credit quality' institutions and securities as those having a long-term credit rating of A- or higher, that are domiciled in the UK or a foreign country with a sovereign rating of AA+ or higher (as published by Fitch, Moody's and Standard & Poor's). The 2016/17 treasury strategy further approved investments in BBB+ rated non-financial organisations (corporates) up to a maximum six month investment duration; the total level of investments with organisations rated below A- being limited to a maximum of £30m (such investments

being classified as 'non-specified' in accordance with DCLG investment guidance).

4.9 The Cabinet Member for Finance and Resources confirms that whilst a prudent investment approach was maintained with priority being given to security and liquidity over the yield achieved, there was however one breach of the Council's approved investment strategy during the first quarter of 2016/17. On 30 June 2016, the repayment of a long-term (three year) investment was received from another local authority back into the Council's old HSBC bank account instead of its Lloyds bank account. The investment was originally placed in May 2013 before the change of the Council's banking services contract from HSBC to Lloyds (October 2013).

4.10 Normal market practice is that investments are repaid back into the originating bank account, unless overriding settlement instructions are provided. Following the Council's change of banks updated settlement instructions were forwarded by officers to all investment counterparties and as a consequence all daily treasury management decisions are made on the expectation of monies being paid from and/or repaid into the Council's main Lloyds bank account. Whilst it has subsequently been confirmed that the local authority in question had received this communication, monies were repaid in error into the Council's old HSBC bank account. The implications of this repayment error were as follows:

(1) Lloyds bank account: £10.3m overdrawn - No breach as the 2016/17 treasury management strategy approves short-term borrowing from "financial institutions authorised by the Prudential Regulation Authority to operate in the UK"; no short-term borrowing costs incurred by the Council.

(2) HSBC bank account: £10.3m credit balance - Credit balances held in current accounts count towards the total unsecured deposits held with a bank. Together with the amount invested in the HSBC three-month notice account (£15m) the amount deposited with HSBC on an unsecured basis totalled £25.3m, breaching the approved £15m monetary limit as set out in the annual investment strategy.

4.11 Council officers identified and corrected the HSBC/Lloyds bank account positions on the next working day and whilst this breach arose as a result of a third party error, the Council has reviewed its internal controls to ensure that future errors of this nature are identified and corrected on the same day as the investment maturity, thereby avoiding any strategy breach. This breach was fully discussed by the Treasury Management Panel and the Regulation, Audit and Accounts Committee at their September 2016 meetings in accordance with approved governance (compliance) arrangements.

4.12 Following advice received from the Council's treasury management advisors (Capita Asset Services) together with support from the Treasury Management Panel, a new investment strategy was approved by County

Council in February 2017 (as contained within the 2017/18 Treasury Management Strategy) which was implemented with immediate effect during the remainder of 2016/17. As a consequence changes to the Council's investment strategy during the quarter included:

(i) To be considered high credit quality non-UK banks must hold a long-term rating of A+ (previously A- in line with UK banks).

(ii) Investment duration limits amended as detailed below:

| **Investment Counterparty** | **Duration Limits** | |
|---|---|---|
| | **Apr 2016** | **Feb 2017** |
| **UK Banks (Unsecured Deposits):** | | |
| Goldman Sachs International Bank | 100 Days | 6 Months |
| Santander UK plc | No Approval | 6 Months |
| Standard Chartered Bank | No Approval | 100 Days |
| Royal Bank of Scotland | Overnight | 364 Days |
| Yorkshire Building Society | No Approval | 100 Days |
| **Non-UK Banks (Unsecured Deposits):** | | |
| Approved Australia Banks | 6 Months | 364 Days |
| Danske Bank (Denmark) | 100 Days | No Approval |
| ING Bank (Netherlands) | 100 Days | No Approval |
| Landesbank Hessen Thuringen-Helaba (Germany) | 6 Months | No Approval |
| Skandinasviska Enskilda Banken (Sweden) | No Approval | 364 Days |
| Swedbank (Sweden) | No Approval | 364 Days |
| Credit Suisse (Switzerland) | 100 Days | No Approval |
| UBS Bank (Switzerland) | No Approval | 364 Days |
| Bank of New York Mellon (US) | No Approval | 364 Days |
| Wells Fargo Bank (US) | No Approval | 364 Days |
| **Multilateral Development Banks:** | | |
| For example, the European Central Bank (ECB) | 364 Days | 2 Years |
| **Non-Bank (Corporates):** | | |
| Corporates Rated A- (Long-Term Rating) | 364 Days | 6 Months |
| Corporates Rated BBB+ (e.g. UK Utilities) | 6 Months | 100 Days |

(iii) Maximum monetary limits for externally managed pooled funds (including Ultra-Short Dated Bond and Property funds) approved as £25m (AAA funds), £15m (other funds) or 5% of a fund's total assets under management, whichever is lower.

4.13 In accordance with the approved treasury management strategy, new investments agreed during 2016/17 included:

**Non-Bank:**

- Short-term investments (up to a maximum of one year) with other UK local authorities: Birmingham City Council, Buckinghamshire County Council, Surrey County Council and Stockport Metropolitan Borough Council.

- Fixed Rate bonds with Corporates (assigned a A- credit rating or above): National Grid Gas plc (UK) and Daimler AG (Germany).
- Fixed rate bonds with UK Utility Companies (BBB+ credit rating): Centrica Plc, London Power Networks Plc, Wales & West Utilities Finance Plc.
- Long-term investment in the CCLA Local Authorities Property Fund.

**Bank Secured:**

- Covered fixed-rate bond (short-term) with Lloyds Bank plc.
- Covered bond (3-year floating rate note) with Nationwide Building Society.

**Bank Unsecured:**

- Short-term fixed deposits and certificate of deposits with UK banks: Close Brothers Ltd, Goldman Sachs International Bank, Lloyds Bank, Nationwide Building Society and the Royal Bank of Scotland.
- The Council maintained the deposits held in both the HSBC 3-month notice account and the Lloyds 175-day notice account throughout 2016/17 (additional £2.5m deposited into the Lloyds notice account during the year).
- 35-day notice and instant access accounts, fixed-term deposits and certificate of deposits with high credit quality non-UK Banks including: Commonwealth Bank of Australia; Toronto-Dominion Bank (Canada); Rabobank (Netherlands); United Overseas Bank (Singapore); Nordea Bank and Svenska Handelsbanken (Sweden).
- Money Market Funds holding a AAA credit rating, operating a constant net asset valuation and holding underlying assets in excess of £1bn: Aberdeen, Blackrock, Deutsche, Federated (UK), Goldman Sachs, and Standard Life and State Street sterling liquidity funds.

**Investment Activity in 2016/17:**

| | **Balance on 1st April (£m)** | **Invest-ments Made (£m)** | **Invest-ments Sold (£m)** | **Balance on 31st March (£m)** |
|---|---|---|---|---|
| UK Banks: Unsecured Deposits | 37.0 | 133.1 | -95.6 | 74.5 |
| UK Banks: Secured Deposits | 17.8 | 17.9 | -27.8 | 7.9 |
| Non-UK Banks: Unsecured | 27.3 | 100.6 | -97.9 | 30.0 |
| Non-Bank Corporates | 7.5 | 38.0 | -33.3 | 12.2 |
| Local Authority | 55.0 | 53.0 | -54.0 | 54.0 |
| Housing Associations | 1.0 | 0.0 | -1.0 | 0.0 |
| Money Market Funds | 69.5 | 979.5 | -994.1 | 54.9 |
| Ultra-Short Dated Bond Funds *(i)* | 20.0 | 0.1 | -5.0 | 15.1 |
| UK Municipal Bond Agency | 0.2 | 0.0 | 0.0 | 0.2 |
| **Total (Exc. Property Funds)** | **235.3** | **1,322.2** | **-1,308.7** | **248.8** |
| Property Funds | | | | 9.2 |
| **Total Investments** | | | | **258.0** |

*(i) £0.1m upward revaluation of the Payden Sterling Reserve Fund during the second quarter of 2016/17.*

4.14 Investments made in 2016/17 were arranged either through approved London money market brokers or by direct dealing with the relevant counterparty. Corporate bonds, covered bonds and certificate of deposits were held via safe custody arrangements administered by King and Shaxson.

4.15 UK banking legislation places the burden of rescuing failing banks disproportionately onto unsecured creditors (including local authority investors) through the potential bail-in of unsecured bank deposits. The use of unsecured bank deposits and short-term Money Market Funds however remained an integral part of the investment strategy in maintaining adequate cash-flow liquidity. As a consequence, the disposition of bank unsecured/other investments at 31 March 2017, as compared with 31 March 2016, is detailed below:

| **Investment Type** | **31-Mar-16** | | **31-Mar-17** | |
|---|---|---|---|---|
| | **£m** | **%** | **£m** | **%** |
| Bank & Building Society Unsecured | 64.3 | 27.3 | 104.5 | 40.5 |
| Money Market Funds | 69.5 | 29.6 | 54.9 | 21.3 |
| **Total Bank Unsecured** | **133.8** | **56.9** | **159.4** | **61.8** |
| Bank Secured (less than 1 year) | 17.8 | 7.6 | 0.0 | 0.0 |
| Bank Secured (greater than 1 year) | 0.0 | 0.0 | 7.9 | 3.1 |
| Non-Bank (less than 1 year) | 21.5 | 9.1 | 50.2 | 19.4 |
| Non-Bank (greater than 1 year) | 42.2 | 17.9 | 16.2 | 6.3 |
| **Internally Managed Investments** | **215.3** | **91.5** | **233.7** | **90.6** |
| Externally Managed - Bond Funds *(i)* | 20.0 | 8.5 | 15.1 | 5.8 |
| Externally Managed - Property Funds | 0.0 | 0.0 | 9.2 | 3.6 |
| **Total Investments** | **235.3** | **100.0** | **258.0** | **100.0** |

*(i) Ultra-Short Dated Bond Funds (Enhanced Cash).*

4.16 At 31 March 2017, non-bank investments in excess of one year includes a total of £16m long-term (3 years) investments arranged with two other local authorities during the last quarter of 2015/16 (Lancashire County Council and Wolverhampton City Council) and a £0.2m shareholding in the UK Municipal Bond Agency Plc.

4.17 The movement in the Council's investment portfolio (actual cash position) by the credit rating of the financial institution, or the credit rating of the specific investment (for example covered bond) if higher than the individual counterparty rating, is shown below:

| **Institution / Investment Credit Rating** | **2015/16** | **2016/17** | | | |
|---|---|---|---|---|---|
| | **31.03.16 £'m** | **30-Jun £'m** | **30-Sep £'m** | **31-Dec £'m** | **31-Mar £'m** |
| AAA | 107.3 | 135.7 | 70.6 | 90.6 | 77.9 |
| AA+ | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| AA | 55.0 | 10.0 | 10.0 | 10.0 | 10.0 |
| AA- | 42.3 | 80.0 | 65.0 | 81.0 | 89.0 |
| A+ | 0.0 | 15.0 | 15.0 | 15.0 | 0.0 |

| Institution / Investment Credit Rating | 2015/16 | 2016/17 | | | |
|---|---|---|---|---|---|
| | 31.03.16 £'m | 30-Jun £'m | 30-Sep £'m | 31-Dec £'m | 31-Mar £'m |
| A | 23.0 | 38.0 | 72.6 | 59.5 | 44.5 |
| A- | 0.8 | 2.3 | 3.3 | 0.0 | 12.2 |
| BBB+ *(i)* | 6.7 | 0.0 | 24.3 | 0.0 | 15.0 |
| CCLA Property Fund | 0.0 | 0.0 | 0.0 | 0.0 | 9.2 |
| UK Municipal Bond Agency | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| **Total Investments** | **235.3** | **281.2** | **261.0** | **256.3** | **258.0** |

*(i) Volkswagen fixed-rate bond (maturity 23 May 2016), UK Utility Companies and the Royal Bank of Scotland (given its part nationalised status).*

4.18 The 2016/17 (and 2017/18) treasury management strategy approved that a maximum of £90m may be invested in non-UK organisations (excluding investments held in short-term Money Market Funds and externally managed Pooled Funds); with a maximum of £30m invested in any one sovereign state. The Council's investment portfolio split by sovereign is shown below:

| Deposits by Sovereign | 2015/16 | 2016/17 | | | |
|---|---|---|---|---|---|
| | 31.03.16 £'m | 30-Jun £'m | 30-Sep £'m | 31-Dec £'m | 31-Mar £'m |
| Australia | 2.3 | 10.0 | 10.0 | 0.0 | 0.0 |
| Canada | 10.0 | 15.0 | 15.0 | 15.0 | 5.0 |
| Germany | 0.8 | 2.3 | 2.3 | 0.0 | 0.0 |
| Netherlands | 6.7 | 15.0 | 15.0 | 15.0 | 0.0 |
| Singapore | 15.0 | 15.0 | 15.0 | 15.0 | 10.0 |
| Sweden | 0.0 | 0.0 | 0.0 | 15.0 | 15.0 |
| **Total (Non-UK)** | **34.8** | **57.3** | **57.3** | **60.0** | **30.0** |
| UK (including Local Authority) | 110.8 | 113.7 | 158.6 | 123.4 | 148.6 |
| Money Market Funds | 69.5 | 90.0 | 24.8 | 52.6 | 54.9 |
| Externally Managed Funds | 20.0 | 20.0 | 20.1 | 20.1 | 24.3 |
| UK Municipal Bond Agency | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| **Total** | **235.3** | **281.2** | **261.0** | **256.3** | **258.0** |

4.19 Counterparty credit quality can be further demonstrated by a benchmarking analysis of the Council's investment portfolio undertaken by the Council's treasury management advisor-Capita Asset Services (CAS):

| Benchmarking Date: 31 March 2017 | Weighted Average Rate of Return | Weighted Average Time to Maturity | Weighted Average Total Time | Weighted Average Credit Risk |
|---|---|---|---|---|
| CAS Client Population Average | 0.55% | 97 | 197 | 3.40 |
| English Counties (CAS Clients) | 0.52% | 86 | 158 | 3.15 |
| West Sussex County Council | 0.57% | 158 | 244 | 2.66 |

4.20 The CAS weighted average credit risk score ranges between 1 (low credit risk) to 7 (high credit risk). The analysis demonstrates that the Council's investment portfolio compares favourably against the average for all CAS

clients and remains comfortably within their recommended credit risk score range.

4.21 **Liquidity Risk**: In keeping with DCLG's Investment Guidance, the Council manages its liquidity position through the risk management procedures above (the setting and approval of prudential and treasury indicators and the approval of the treasury and investment strategy reports). As required by the CIPFA Code of Practice, the Council uses purpose built cash flow forecasting software (SAP Treasury Management Module) to determine the maximum period for which funds may prudently be invested.

4.22 The maturity profile of County Council investments throughout 2016/17 is shown below:

| Period to Maturity | 2015/16 | 2016/17 | | | |
|---|---|---|---|---|---|
| | 31.03.16 £'m | 30-Jun £'m | 30-Sep £'m | 31-Dec £'m | 31-Mar £'m |
| Instant Access Accounts | 69.5 | 90.0 | 45.4 | 52.6 | 54.9 |
| Up to one month | 10.0 | 0.0 | 34.6 | 10.0 | 20.0 |
| One month to 3 months | 44.0 | 45.0 | 69.8 | 90.0 | 42.2 |
| 3 months to 6 months | 37.0 | 57.1 | 52.0 | 44.5 | 69.5 |
| 6 months to 1 year | 38.6 | 45.0 | 15.0 | 15.0 | 23.0 |
| Greater than 1 year *(i)* | 16.2 | 24.1 | 24.1 | 24.1 | 33.3 |
| Ultra-Short Dated Bond Fund | 20.0 | 20.0 | 20.1 | 20.1 | 15.1 |
| **Total** | **235.3** | **281.2** | **261.0** | **256.3** | **258.0** |

*(i) £45m total long-term investment limit (as per 2017/18 Treasury Management Strategy) including the CCLA Property Fund investment.*

4.23 **Short-term (borrowing for cash flow purposes)**: The Council has ready access to short-term borrowings from the money markets to cover any day-to-day cash flow needs. On three occasions during 2016/17 the Council's overdrawn position of its main bank account held with Lloyds exceeded £1m which in accordance with the Treasury Management Strategy represented short-term borrowing for a period of one working day:

(1) £10.3m overdrawn with Lloyds on 30 June 2016 (see paragraphs 4.9 to 4.11).

(2) £17.1m overdrawn with Lloyds on 8 November 2016 following maturity of a Lloyds covered bond, which whilst being settled by Lloyds in advance of daily deadlines for banking payments was not actually received within the Council's custody account until after this deadline. As a consequence settlement from the Council's custodian (administered by King & Shaxson Ltd) back to its main Lloyds bank account could not be processed until the next working day, causing the Lloyds account to be overdrawn. Whilst efforts were made on the day to expedite repayment to the Council, all holders of this Lloyds £0.5bn bond issue were impacted by the late payment in the same

way irrespective of the custodian holding this bond on behalf of their clients.

(3) £7.1m overdrawn with Lloyds and JP Morgan Chase Bank on 23 March 2017 following an officer processing error regarding transactions in/out of the Council's instant access accounts to cover a daily cash flow shortage. Whilst the error was identified the same day as it occurred and immediately investigated it could not be corrected until the next working day due to intra-day dealing deadlines. Short-term borrowing is within the parameters of the Treasury Management Strategy; controls to prevent such errors occurring have been subsequently reviewed and were deemed adequate.

4.24 Whilst no additional bank charges were incurred by the Council in relation to the first two overdrawn positions (third party errors) the Council did incur bank charges totalling £342 as a consequence of the third overdrawn position.

4.25 With the exception of the above and excluding money held on behalf of the Chichester Harbour Conservancy (and its associated charities) no other short-term borrowing for cash flow purposes was undertaken during 2016/17. All daily cash flow shortages were funded by withdrawals from the Council's instant access accounts (including short-term Money Market Funds).

4.26 **Re-Financing Risk**: The Council maintains a significant debt and investment portfolio. Longer-term risks to the Council relate to managing the exposure of replacing financial instruments as they mature. These risks relate to both the maturing of longer-term borrowing and longer-term investments. The premium charge associated with early repayment of Public Works Loan Board debt remained relatively expensive for the loans in the Council's portfolio and therefore unattractive for debt rescheduling. As a consequence none of the Council's long-term debt was rescheduled in 2016/17; however rescheduling opportunities continue to be periodically reviewed in consultation with the Council's treasury management advisors (Capita Asset Services).

4.27 **Other Market Risks**: Inflation risks gives rise to the possibility of a diminution of the spending powers of the Council's cash holdings, or the potential escalation of its borrowing costs if linked to inflation indices. Throughout 2016/17 the Council achieved a 0.67% return on its investment portfolio (Section 5) as compared against average UK CPI inflation of 1.12% during the same period. Whilst not holding any inflation linked borrowings, the Council looked to partially mitigate the resulting inflationary risks evident on its investments through its prescribed cash flow procedures; including the identification of reserves (for example PFI reserves) that may be set aside for longer-term (higher yielding) investments.

4.28 The Council's investment in the CCLA Local Authorities Property Fund (commencing March 2017) is subject to the risk of falling commercial property prices. This risk is limited by the maximum exposure to property pooled funds and the overall limit for long-term investments approved within the Treasury Management Strategy. Under current accounting regulations units in property funds are classified as 'available for sale'; meaning that all movements in price will impact on gains and losses reported in the Available for Sale Financial Instrument Reserve and therefore have no impact on the General Fund until the investment is sold.

4.29 With the exception of the shareholding held with the UK Municipal Bond Agency (promoting an additional funding source for the public sector other than PWLB and market loans) the Council did not invest in equity shares or externally managed equity pooled funds during 2016/17. Furthermore, the Council had no investments or borrowings denominated in foreign currencies and therefore had no exposure to losses arising from movements in exchange rates.

**5. Investment Performance**

5.1 The actions taken by the Bank of England in the aftermath of the Brexit referendum meant that the UK Base Rate averaged 0.34% throughout 2016/17; lower than what had been originally forecast in the Treasury Management Strategy (paragraph 4.4). As a consequence short-term money rates also remained at very low levels (as shown in table within paragraph 2.8) which continued to have a significant impact on investment income. The low rates of return on the Council's short-dated money market investments therefore reflected both prevailing market conditions and the Cabinet Member for Finance and Resources primary objective of optimising returns commensurate with the principles of security and liquidity.

5.2 At the start of 2016 the Cabinet Member for Finance and Resources forecast that gross investment income totalling £2.26m would be received in 2016/17, based on the assumption that the Council could achieve an average interest rate of 0.84% on an assumed investment portfolio of £270m (forecast assuming an average UK Bank Rate of 0.7% during the period). The investment income budget as reported in the 2016/17 Revenue Budget included estimated transfers to (£0.653m) / from (£0.257m) internal balances held by the Council (including school accumulating funds, PFI and interest smoothing reserves) and balances held on behalf of the Chichester Harbour Conservancy and the Local Enterprise Partnership (LEP).

| | **£'000** |
|---|---|
| Expected interest receipts on investment portfolio | 2,260 |
| Budgeted transfers to internal balances and third parties | -653 |
| Budgeted transfers from the Interest Smoothing Reserve | 257 |
| **Revenue Budget (Investment Income)** | **1,864** |

5.3 During the second quarter of 2016/17, interest forecasts were revised to show an additional £0.43m shortfall against the investment income revenue budget on updated interest rate forecasts following the Brexit outcome; increasing the expected transfer from the interest smoothing reserve to £0.687m (as reported in the August 2016 Total Performance Monitor).

5.4 Actual gross investment interest received in 2016/17 was £1.882m (£2.3m in 2015/16) representing a return of 0.67% on an average investment portfolio of £282m. The actual rate of return achieved on the Council investments (0.67%) was lower than the originally forecast (0.84%). The resulting interest shortfall was partially offset by higher than expected average investment balances, a consequence of capital programme slippage and LEP monies still to be allocated to third parties.

5.5 At 31 March 2017, £0.498m interest was paid to third parties (including the LEP and Chichester Harbour Conservancy) and other internal balances held by the Council (including PFI reserves and school accumulating funds); £0.155m lower than the original budget forecast (paragraph 5.2) due to the cut in the UK Bank Rate in August 2016 lowering short-term rates.

5.6 Following interest payments to third parties and internal reserves, at 31 March 2017 net interest totalled £1.395m. Included within this amount was other non-investment interest received by the Council during 2016/17 (£0.011m); which included interest receivable on school capital loans. As a consequence, to meet the approved 2016/17 investment income revenue budget (£1.864m), £0.469m was drawn down from the interest smoothing reserve funding the interest shortfall at 31 March 2017 (lower than the updated £0.687m forecast made in aftermath of Brexit).

5.7 At 1 April 2016 the interest smoothing reserve totalled £0.88m. Following the drawdown to fund the 2016/17 interest shortfall, together with a £0.419m transfer back into the reserve (approved within the year-end Total Performance Monitor) the balance remaining in the interest smoothing reserve at 31 March 2017 totalled £0.83m.

5.8 The actual performance of investment income throughout 2016/17 (detailed above) as compared against the original revenue budget forecast (paragraph 5.2) is summarised below:

| | **£'000** |
|---|---|
| **Expected Interest Receipts on Investment Portfolio** | **2,260** |
| Lower rate of return than assumed budgeted rate (-0.17%) | -479 |
| Higher average investment portfolio than budgeted (at 0.84%) | 101 |
| **Actual Interest Received on Investment Portfolio** | **1,882** |
| Other interest received (including school capital loans) | 11 |
| Interest paid to third parties, internal reserves and LEP | -498 |
| **Net Interest Received (2016/17)** | **1,395** |
| Transfer from Interest Smoothing Reserve (to offset shortfall) | 469 |
| **Revenue Budget (Investment Income)** | **1,864** |

5.9 Included within the investment interest received (£1.882m) interest receipts from variable rate investments, including instant access bank accounts, Money Market Funds, bank notice accounts, variable rate covered bonds, equity and externally managed pooled funds amounted to £0.72m, representing an average interest rate of 0.54% (see below):

| Account | Average Balance £'m | Interest Received £'000 | Rate of Return % |
|---|---|---|---|
| Bank instant access accounts | 0.6 | 2.1 | 0.35 |
| Short-term Money Market Funds | 78.5 | 296.5 | 0.38 |
| Bank notice accounts | 25.0 | 148.2 | 0.59 |
| Payden Sterling Reserve Fund | 19.9 | 168.7 | 0.85 |
| Bank Secured (Floating Rate Note) | 7.4 | 68.5 | 0.93 |
| CCLA Property Fund | 0.9 | 35.8 | 4.22 |
| UK Municipal Bond Agency *(i)* | 0.2 | 0.0 | 0.0 |
| **Total** | **132.5** | **719.8** | **0.54** |

*(i) Whilst the Council does not expect to receive any investment returns in the immediate future regarding this equity investment, given the expected long-term borrowing requirement over the next five to ten years it is hoped that the Council may benefit from a realistic Local Government funding alternative to the Public Works Loan Board.*

## 6. Pooled Funds Performance

6.1 Externally managed pooled funds differ from cash (short-term) Money Market Funds used by the Council as they operate on a 'variable net asset valuation' which introduces volatility into the unit price. Pooled funds allow the Council to diversify its investment portfolio into asset classes other than cash without the need to own and manage the underlying investments (which is undertaken by a professional fund manager in return for a fee). Additionally these funds provide the potential for enhanced returns when viewed over the medium to long-term. At 31 March 2017 the Council held investments within the following pooled funds:

| Fund | Type | Rating | Fund Size | Maximum Allowable Investment (31/03/17) | Current Investment *(Market Valuation)* |
|---|---|---|---|---|---|
| CCLA | Property | n/a | £708m | £15m | £9.2m |
| Payden | Ultra-Short Dated Bond | AAA | £344m | £17m | £15.1m |

6.2 An overview of the investment activity in the Council's externally managed pooled funds throughout 2016/17 is shown below:

| Fund | Market Valuation 31-Mar-16 | Payments in/out(-) | Market Gain/Loss(-) | Dividends Received | Dividend Return *(i)* |
|---|---|---|---|---|---|
| CCLA | £0.0m | £10.0m | -£0.8m | £35,803 | 4.22% |
| Payden | £20.0m | -£5.0m | £0.1m | £168,684 | 0.85% |

*(i) Based on the average nominal investment amount (per fund).*

6.3 The Payden fund is externally managed to provide a diverse portfolio of high quality sterling denominated investments, that provides a high degree of liquidity and comprises UK government and government guaranteed securities, covered bonds (high credit quality 'bail-in' exempt bank securities) and investment grade corporate bonds. In accordance with new monetary exposure limits approved within the Council's 2017/18 Treasury Management Strategy (5% of the total fund size) £5m was withdrawn from the fund during the fourth quarter of 2016/17. On sale the Council realised a capital gain of £27,075; shown as an additional dividend in the above table.

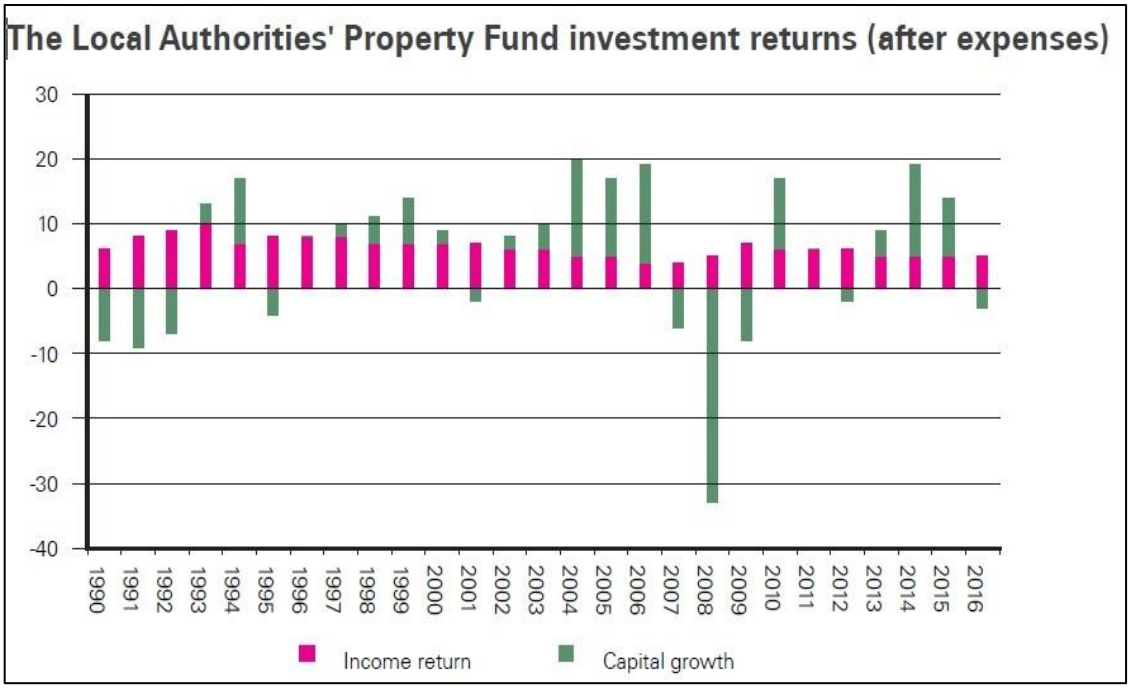
6.4 During 2016 the Treasury Management Panel undertook a detailed evaluation of a range of externally managed pooled funds including strategic bond, equity income and property funds, supported by our external advisors. As part of the evaluation exercise the Panel considered the volatility, asset allocation and historic performance of each selected fund. Based on the outcomes of this exercise the Council invested £10m into the Local Authorities Property Fund (CCLA) at the end of February 2017. This fund is an unregulated collective investment scheme available exclusively to local authority investors; established under a Scheme approved by HM Treasury (under Section 11 of the Trustees Investments Act 1961) and governed by the Local Authorities' Mutual Investment Trust (LAMIT). The fund actively manages a diversified portfolio of high quality UK commercial property, having the objective of providing both long-term capital growth and the generation of regular income through quarterly dividends.

6.5 Whilst the Council's investment in the CCLA fund is made in accordance with the approved 2016/17 and 2017/18 treasury management strategies, it is acknowledged that the use of property as an investment asset class introduces additional risks that are mitigated through the intention to hold the investment over a long-term (minimum 5-year) period. Specific risks discussed by the Treasury Management Panel as part of the evaluation exercise included:

(a) **Security Risks**: The Council's investments in externally managed property funds are subject to the risk of falling commercial property prices given prevailing sector conditions; therefore a local authority investor may not get back the amount originally invested. Whilst historic performance cannot be used to guarantee future performance, it can be shown that dividend (investment income) returns from the CCLA Property Fund have remained relatively stable since 2004 (circa 5%) even between 2007 and 2009 when the fund experienced significant capital depreciation during the financial crisis and corresponding property downturn. Additionally, since 1990 it can be shown that there have been more years of capital growth as compared to the number of years of capital loss (as set out in the graph below).

(b) **Liquidity Risks**: Property is an illiquid asset class and whilst the fund maintains a small percentage cash holding, it is unlikely that a local

authority investor will be able to withdraw funds immediately. A withdrawal request may require the fund manager to arrange for a property to be sold to make funds available. Consequently there is no defined settlement timeframe (as seen with the ultra-short dated bond funds used by the Council) and redemption requests can take up to six months before repayment is received. This investment is being viewed over a longer period in accordance with the approved 2017/18 Treasury Management Strategy *[TMSS paragraphs 7.13(4); 8.3 and 8.4]*.




6.6 In addition to the security and liquidity risks outlined above, on commencement of the Council's investment within the fund, units were valued at an "offer-price" (the price at which new units are acquired); however on an ongoing basis units are then valued at a 'bid-price' (the price at which units can be sold back to the fund manager). The bid/offer spread (currently 8.3%) reflects the true cost of dealing in the underlying assets and takes account of applicable Stamp Duty Land Tax (SDLT) on purchases of commercial property. Whilst the market valuation of the Council's investment was set at the fund's 'bid-price' at the 31 March 2017, when viewed over a long-term (minimum 5-year) horizon it is expected that capital growth within the fund will increase the Council's holding to at least par when compared against the original £10m investment.

6.7 The Treasury Management Panel, together with Capita Asset Services support, will continue to monitor the performance and suitability of both existing and potential new funds during 2017/18. With regard to ultra-short dated bond funds, such investments will be withdrawn if any concerns relating specifically to the fund itself materialise, or if any suitable investment alternative becomes available.

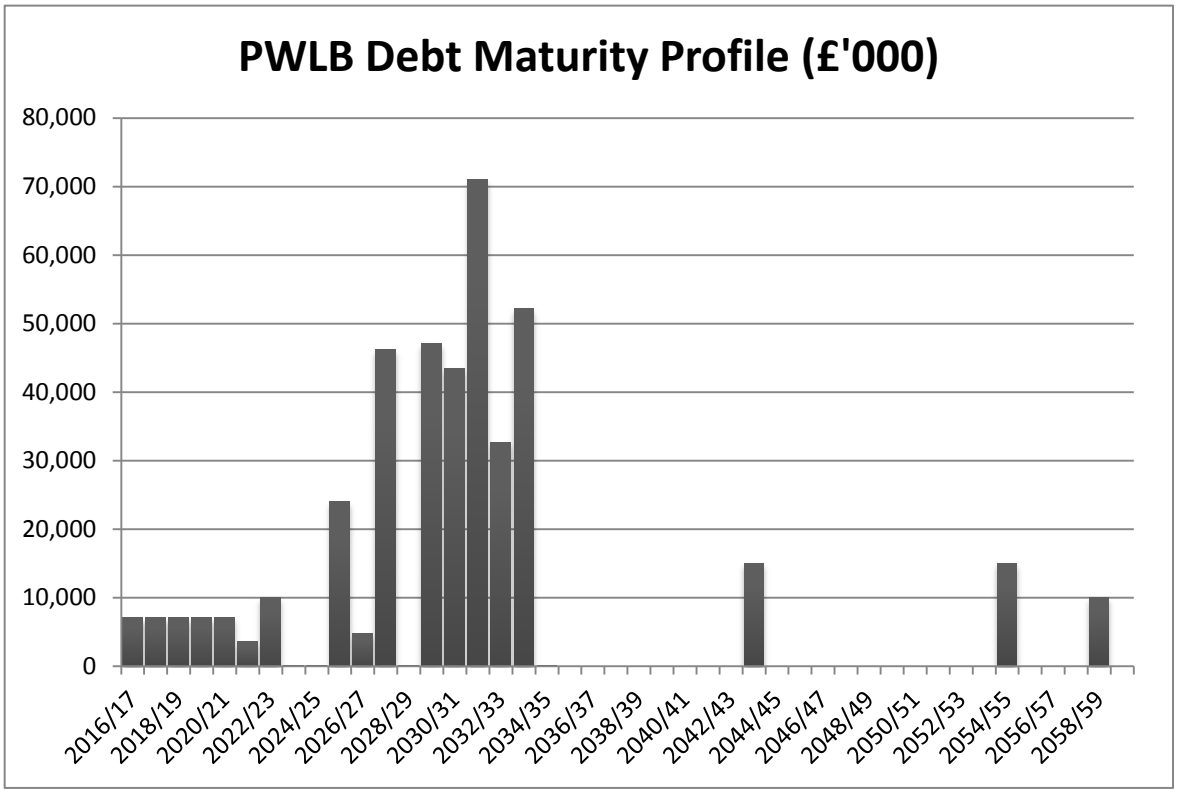
## 7. Borrowing

7.1 In accordance with CIPFA's Prudential Code the County Council continues to approve external borrowing to finance part of the capital programme. The Council's main objective when approving new external borrowing is to strike an appropriately low risk balance between securing low interest costs and achieving a cost certainty over the period for which funds are required; flexibility to renegotiate loans should the Council's long-term capital plans change being a secondary objective.

7.2 Affordability also remains an important influence on the Council's borrowing strategy. Any borrowing in advance of need currently introduces a 'cost of carry' where proceeds are temporarily reinvested at interest rates significantly lower than the cost of borrowing. As short-term interest rates have remained, and are likely to remain lower than long-term rates to the end of 2018, the Cabinet Member for Finance and Resources determined that an internal borrowing strategy, whereby the Council is using its own resources in lieu of external borrowing, would be the most cost effective policy in 2016/17 (£41.3m internal borrowing as at 31 March 2017). No new external borrowing was therefore undertaken during the period; £7.0m (plus interest) was however repaid to Public Works Loan Board (PWLB) relating to the £70m borrowing taken during April 2011, as per agreed terms and conditions.

7.3 In accordance with the CIPFA Prudential Code the Council is required to set an annual Minimum Revenue Provision (MRP) policy on the way it calculates the prudent provision for the charge to the revenue account for borrowing. During 2016/17 the Council (with support from its external treasury advisor) undertook a review of the MRP policy which demonstrated that changing the method of calculation to an annuity basis would provide a fairer charge to the taxpayers of West Sussex. This decision was approved by County Council in December 2016 and was applied to the 2016/17 charge.

7.4 The Council's total external borrowing at 31 March 2017 (the funding of previous years' capital programmes; all arranged via the PWLB) including the loan undertaken on behalf of the Littlehampton Harbour Board in March 2015 (all related costs recoverable from the Harbour Board) was £402.9m (£409.9m at 31 March 2016) with the following maturity profile:




7.5 Interest payable to the PWLB relating to the Council's long-term borrowing amounted to £18.3m in 2016/17 (£18.6m in 2015/16), representing an average interest rate of 4.53%. If the Council had externalised its internal borrowing on 1 April 2016 (£44.7m) it is estimated that the additional revenue cost in 2016/17 relating to interest payments would have been £1.4m (based on a 25 year PWLB maturity loan at 3.14%; paragraph 2.9).

7.6 The Council's long-term borrowing portfolio was periodically reviewed throughout 2016/17, in consultation with the Council's treasury management advisor (Capita Asset Services), to consider:

- the benefits of maintaining an internal borrowing strategy against the potential for incurring additional costs by deferring borrowing into future years (when long-term borrowing rates are forecast to rise); and

- external borrowing rates in anticipation of the borrowing requirement in future years, with a view to potentially undertake forward borrowing should there be an indication that interest rates are likely to increase.

(see Appendix, paragraph 4.3, page 103)

## Prudential and Treasury Indicators (Compliance)

### 1 Gross Debt and the Capital Financing Requirement

1.1 In order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external debt does not, except in the short-term if borrowing in advance of need has been approved, exceed the total of the 2016/17 Capital Financing Requirement plus the estimates of any additional Capital Financing Requirement for 2017/18 and the next two financial years; this essentially demonstrates that the Council is not borrowing to support revenue expenditure. The table below shows that at 31 March 2017 the Council's gross external debt has not exceeded its Capital Financing Requirement:

| | **Original Estimate 2016/17 £'000 *(TMSS-16/17)*** | **Revised Estimate 2016/17 £'000 *(TMSS-17/18)*** | **Actual Position 31 Mar 17 £'000** |
|---|---|---|---|
| Capital Expenditure | 158,339 | 126,016 | 103,598 |
| Capital Financing Requirement | 615,593 | 585,610 | 561,686 |
| Gross External Debt (including short/long-Term Borrowing, PFI and Finance Leases) | 568,355 | 520,557 | 520,405 |

### 2 Authorised Limit and Operational Boundary for External Debt

2.1 The Authorised Borrowing Limit is a statutory limit determined under Section 3 of the Local Government Act 2003 (referred to in the legislation as the "Affordable Limit"). This limit sets the maximum level of external debt on a gross basis (excluding all investments) for the Council. It is measured on a daily basis against all external debt items on the Council's Balance Sheet, including:

- Long-term borrowing
- Short-term borrowing
- Overdrawn bank balances
- Other long-term liabilities (PFI / Finance Leases)

| | **Original Estimate 2016/17 £'000 *(TMSS-16/17)*** | **Revised Estimate 2016/17 £'000 *(TMSS-17/18)*** | **Actual Position 31 Mar 17 £'000** |
|---|---|---|---|
| External Borrowing (Capital) | 453,124 | 402,882 | 402,882 |
| External Borrowing (Other) | 43,800 | 44,000 | 4,239 |
| PFI Schemes & Finance Leases | 118,447 | 113,675 | 113,284 |
| Authorised Borrowing Limit | 615,371 | 560,557 | 520,405 |

2.2 The Operational Boundary (borrowing limit) links directly to the Council's

estimates of the Capital Financing Requirement. This indicator is based on the same estimates as the Council's Authorised Borrowing Limit and reflects the maximum borrowing required to meet capital spending plans, without the additional £40m headroom included within the Authorised Limit required in meeting unusual (short-term) cash flow movements.

| | **Original Estimate 2016/17 £'000** ***(TMSS-16/17)*** | **Revised Estimate 2016/17 £'000** ***(TMSS-17/18)*** | **Actual Position 31 Mar 17 £'000** |
|---|---|---|---|
| External Borrowing (Capital) | 453,124 | 402,882 | 402,882 |
| External Borrowing (Other) | 3,800 | 4,000 | 4,239 |
| PFI Schemes & Finance Leases | 118,447 | 113,675 | 113,284 |
| Operational Borrowing Limit | 575,371 | 520,557 | 520,405 |

2.3 The Council confirms that there were no breaches of the Council's Operational and Authorised Borrowing Limits during 2016/17.

**3 Adoption of the CIPFA Treasury Management Code**

3.1 The County Council approved the adoption of the CIPFA Treasury Management Code of Practice (2009) into the Treasury Management Policy Statement as detailed within the Council's Financial Regulations at its meeting dated 11 February 2011. Further amendments to the CIPFA Treasury Management Code were announced during 2011 and the County Council adopted these changes from 1 April 2012.

**4 Upper Limits for Fixed and Variable Interest Rate Exposure**

4.1 These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates. The Council calculates these limits on the principal outstanding sums as compared with the respective total borrowing and investment levels.

4.2 The upper limits for variable interest rate exposure have been set with regard to current economic forecasts, to ensure that the Council is not exposed to interest rate rises which could adversely impact the revenue budget.

| | **Approved Limits 2016/17** | **Actual Position 31 Mar 17** |
|---|---|---|
| Maximum % Borrowing at Fixed Rates | 100% | 100% |
| Maximum % Borrowing at Variable Rates | 25% | 0% |
| Maximum % Investments at Fixed Rates | 100% | 57% |
| Maximum % Investments at Variable Rates | 85% | 43% |

4.3 The Council confirms that there were no breaches of these limits during 2016/17.

## 5 Maturity Structure of Fixed Rate Borrowing

5.1 This indicator highlights the existence of any large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates, and is designed to protect against excessive exposures to interest rate changes in any one period, in particular over the course of the next ten years.

| Treasury Management | Lower Limit 2016/17 (%) | Upper Limit 2016/17 (%) | Actual Fixed Rate Borrowing 31 Mar 17 (£'000) | Fixed Rate Borrowing 31 Mar 17 (%) |
|---|---|---|---|---|
| Over 30 Years | 0% | 10% | 25,000 | 6% |
| Over 25 to 30 Years | 0% | 10% | 15,000 | 4% |
| Over 20 to 25 Years | 0% | 10% | 0 | 0% |
| Over 15 to 20 Years | 0% | 50% | 84,847 | 21% |
| Over 10 to 15 Years | 0% | 60% | 207,678 | 51% |
| Over 5 to 10 Years | 0% | 20% | 38,778 | 10% |
| Over 1 to 5 Years | 0% | 20% | 24,563 | 6% |
| Under 12 Months | 0% | 15% | 7,016 | 2% |
| | | | **402,882** | **100%** |

5.2 The Council confirms that there were no breaches of these limits during 2016/17.

## 6 Upper Limit for Principal Sums Invested over 364 Days

6.1 The purpose of this limit is to contain exposure to the possibility of loss that may arise as a result of the Council having to seek early repayment of the sums invested.

| | Upper Limit 2016/17 | Revised Limit *(TMSS-17/18)* | Actual Position 31 Mar 17 |
|---|---|---|---|
| Maximum invested for longer than a year (£) | £100m | £45m | £33.3m |

6.2 The Council confirms that there were no breaches of this limit during 2016/17.