Appendix A

Treasury Management Annual Report 2014/15

Introduction

Treasury management is defined as: "The management of the local authority'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. Treasury Year End Position

The amount of investments outstanding at 31st March 2015 was £47.7m (compared to £61.1m as at 31 March 2014) as follows:

	31/03/14	**31/03/15**
	£m	**£m**
UK BANKS		
Barclays Bank	5.0	5.2
Lloyds TSB	3.0	2.0
Santander (UK)	5.3	-
Close Bros	3.0	-
Standard Chartered Bank	2.0	-
FOREIGN BANKS		
Deutsche Bank (Germany)	-	6.0
Svenska Handelsbanken (Sweden)	-	5.0
BUILDING SOCIETIES		
Nationwide Building Society	2.0	5.0
Yorkshire BS (Covered Bond)	-	5.0
Coventry Building Society	-	1.0
Cumberland Building Society	-	1.0
Leeds Building Society	-	1.0
MONEY MARKET FUNDS		
Federated Investors	5.9	3.9
Morgan Stanley	4.5	3.5
IGNIS	7.6	2.5
Aberdeen Asset (formerly Scottish Widows)	1.5	1.6
Deutsche	0.9	-
MANAGED FUNDS		
Property Funds	-	5.0
Investec – Pooled Funds	20.4	-
TOTAL	**61.1**	**47.7**

The net investment income received in 2014/2015 after allowing for fees and interest due to the Growing Places fund was £1.1m. This is favourable compared to the budget of £200,000. However, this includes the full realised income from the sale of our externally managed investments of which £417,000 relates to previous years.

The overall average rate of interest on all investments in 2014/15 was 0.74% compared to the benchmark 7 day LIBID average return of 0.44%. The base rate remained at 0.50% for the full year.

Investment income forms part of the capital financing budget, which also includes the amount charged in respect of the repayment of outstanding debt and the amount of interest payable on the Council's portfolio of long term loans. The capital financing budget for 2014/15 was £12.4m which accounts for 4.9% of the Council's total revenue budget. Additional investment income and lower external interest charges contributed to a £1.8m underspend on capital financing which has been transferred to reserves for funding future capital expenditure.

We will continue to monitor performance during 2014/15 through the benchmarking service provided by the Council's Treasury Management Advisors, Arlingclose.

2. Interest Rates and Prospects for 2014/15

The Councils' treasury advisors, as part of their service assisted in formulating a view on interest rates. However, there has been no change to the bank base rate since March 2009.

3. Compliance with Treasury Limits

During the financial year the Councils' operated within the treasury limits and Prudential Indicators set out in the Councils' Treasury Policy Statement and annual Treasury Strategy Statement (see section 7).

4. Investment Strategy for 2014/15

The Council had regard to the DCLG Guidance on Local Government Investments ("the Guidance") issued in March 2004 (revised in 2010) and the revised CIPFA Treasury Management Code and the revised Prudential Code ("the CIPFA TM Code").

Investment instruments identified for use in the financial year are set through the Councils' Treasury Management Strategy Statement and Investment Strategy. Different limits apply to counterparties based on a range of credit criteria which governs the maximum amount and the maximum maturity periods of any investments. This is kept under continual review with institutions added or removed from our list of counterparties during the year dependent on their qualification according to the credit criteria measures.

Investment Objectives

All investments were in sterling. The general policy objective of the Council was the prudent investment of its treasury balances. The Councils' investment priorities are the security of capital and liquidity of its investments.

The Council aimed to achieve the optimum return on its investments commensurate with the proper levels of security and liquidity. The DCLG maintains that the borrowing of monies purely to invest or on-lend and make a return is unlawful and this Council will not engage in such activity.

Credit Risk

Counterparty credit quality was assessed and monitored with reference to credit ratings; credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP; any potential support mechanisms and share price.

The maximum amount that can be invested with any one organisation is set in the Treasury Management Strategy Report. For named UK banks and credit rated building societies this has been set at 10% of our total investments subject to a maximum value of £10m (now revised to £5m). These limits apply to the banking group that each bank belongs to.

Limits for each Money Market fund have been set at a maximum value of £10m per fund with a limit of 25% of total investments per fund although operationally this is limited to 10% in line with updated guidance. There is also a maximum that can be invested in all Money Market Funds at any one time of 50% of the value of all investments. Due to their smaller size, unrated Building Societies have a limit of £1m each.

Counterparty update

The European Parliament approved the EU Bank Recovery and Resolution Directive (BRRD) on April 15, 2014. Taking the view that potential extraordinary government support available to banks' senior unsecured bondholders will likely diminish, over 2014-15 Moody's revised the Outlook of several UK and EU banks from Stable to Negative (note, this is not the same as a rating review negative) and S&P placed the ratings of UK and German banks on Credit Watch with negative implications, following these countries' early adoption of the bail-in regime in the BRRD.

The Bank of England published its approach to bank resolution which gave an indication of how the reduction of a failing bank's liabilities might work in practice. The Bank of England will act if, in its opinion, a bank is failing, or is likely to fail, and there is not likely to be a successful private sector solution such as a takeover or share issue; a bank does not need to be technically insolvent (with liabilities exceeding assets) before regulatory intervention such as a bail-in takes place.

In October following sharp movements in market signals driven by deteriorating global growth prospects, especially in the Eurozone, Arlingclose advised a reduction in investment duration limits for unsecured bank and building society investments to counter the risk of another full-blown Eurozone crisis. Durations for new unsecured investments with banks and building societies which were previously reduced. Duration for new unsecured investments with some UK institutions was further reduced to 100 days in February 2015.

The outlawing of bail-outs, the introduction of bail-ins, and the preference being given to large numbers of depositors other than local authorities means that the risks of making unsecured deposits rose relative to other investment options. The Council therefore increasingly favours secured investment options or diversified alternatives such as covered bonds, non-bank investments and pooled funds over unsecured bank and building society deposits.

Liquidity

In keeping with the CLG's Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds / overnight deposits/ the use of call accounts.

Yield

The Council sought to optimise returns commensurate with its objectives of security and liquidity. The UK Bank Rate was maintained at 0.5% through the year. Short term money market rates also remained at very low levels which continue to have an impact on investment income.

Use of External Fund Managers

During 2014/15 the Council completed the planned withdrawal from Investec and redeemed its £20m investment. Alternative investments have since made including the CCLA Property Fund.

CCLA manage charity and public sector client investments and are regulated by the Financial Conduct Authority (FCA). Its clients include charities, churches and faith groups, local authorities and other public sector bodies.

The Local Authorities' Property Fund is a diversified commercial and industrial property portfolio available to all local authorities. It is suitable where long term funds are available to invest to achieve an attractive income and capital growth over time.

The Council invested £5m into the fund in October 2014. At close of business the value of the fund was £4,997,649 this is due to the difference in the purchase price of the units and the current selling price, there is normally a 7% difference between the two.

The dividends received in the five months to 31 March 2015, amount to £100k, an average rate of 4.8% return. This compares to the rest of the Council's investments, where the average return is currently forecast at around 1%.

CCLA also manage a Public Sector Deposit Fund (PSDF) which the Council uses as an instant access account with returns of around 0.4%.

A further investment of £2.5m has been made in the Property Fund in 2015.

5. Borrowing strategy

At the end of the year 2014/15 the Council had debt outstanding of £114.4m. Of this £17m represented loans raised from commercial banks whilst £97.4m represented loans from the PWLB.

The Council's capital financing requirement (CFR) currently exceeds the amounts actually borrowed with the shortfall being funded from cash balances.

In accordance with the Treasury Management Strategy the Council sought to finance its capital expenditure through the use of its own existing cash balances rather than through the raising of long term loans. The benefits of this are twofold; firstly by reducing the amount of cash balances held by the Council it reduces the credit risk and secondly, the interest foregone on the cash balances use to finance capital expenditure payments was less than the amount of interest payable on any new loans that would have been raised.

6. Economic events of 2014/15

The robust pace of GDP growth of 3% in 2014 was underpinned by a buoyant services sector, supplemented by positive contributions from the production and construction sectors. Resurgent house prices, improved consumer confidence and healthy retail sales added to the positive outlook for the UK economy given the important role of the consumer in economic activity.

Annual CPI inflation fell to zero for the year to March 2015, down from 1.6% a year earlier. The key driver was the fall in the oil price (which fell to $44.35 a barrel a level not seen since March 2009) and a steep drop in wholesale energy prices with extra downward momentum coming from supermarket competition resulting in lower food prices. Bank of England Governor Mark Carney wrote an open letter to the Chancellor in February, explaining that the Bank expected CPI to temporarily turn negative but rebound around the end of 2015 as the lower prices dropped out of the annual rate calculation.

The UK labour market continued to improve and remains resilient across a broad base of measures including real rates of wage growth. January 2015 showed a headline employment rate of 73.3%, while the rate of unemployment fell to 5.7% from 7.2% a year earlier. Comparing the three months to January 2015 with a year earlier, employee pay increased by 1.8% including bonuses and by 1.6% excluding bonuses.

The Bank of England's MPC maintained interest rates at 0.5% and asset purchases (QE) at £375bn. Its members held a wide range of views on the response to zero CPI inflation, but just as the MPC was prepared to look past the temporary spikes in inflation to nearly 5% a few years ago, they felt it appropriate not to get panicked into response to the current low rate of inflation. The minutes of the MPC meetings reiterated the Committee's stance that the economic headwinds for the UK economy and the legacy of the financial crisis meant that increases in the Bank Rate would be gradual and limited, and below average historical levels.

Political uncertainty had a large bearing on market confidence this year. The possibility of Scottish independence was of concern to the financial markets, however this dissipated following the outcome of September's referendum.

Gilt Yields and Money Market Rates: From July, gilt yields were driven lower by a combination of factors: geo-political risks emanating from the Middle East and Ukraine, the slide towards deflation within the Eurozone and the big slide in the price of oil and its transmission though into lower prices globally. 5-, 10- and 20-year gilt yields fell to their lows in January (0.88%, 1.33% and 1.86% respectively) before ending the year higher at 1.19%, 1.57% and 2.14% respectively.

7. Prudential Indicators 2014/15

The Council can confirm that it has complied with its Prudential Indicators for 2014/15, approved on 27th February 2014 as part of the Council's Treasury Management Strategy Statement. Details can be found in Annex 1.

In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during 2014/15. None of the Prudential Indicators have been breached and a prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield.

Annex 1

Prudential Indicators 2014/15 and revisions to 2015/16 – 2017/18

1. **Background:**
There is a requirement under the Local Government Act 2003 for local authorities to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the "CIPFA Prudential Code") when setting and reviewing their Prudential Indicators.

2. **Gross Debt and the Capital Financing Requirement:**
This is a key indicator of prudence. In order to ensure that over the medium term debt will only be for a capital purpose, the local authority should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years.
If in any of these years there is a reduction in the capital financing requirement, this reduction is ignored in estimating the cumulative increase in the capital financing requirement which is used for comparison with **gross** external debt.
The Chief Operating Officer reports that the Authority had no difficulty meeting this requirement in 2014/15, nor are there any difficulties envisaged for future years. This view takes into account current commitments, existing plans and the proposals in the approved budget.

3. **Capital Expenditure:**

3.1 This indicator is set to ensure that the level of proposed capital expenditure remains within sustainable limits and, in particular, to consider the impact on Council Tax.

Capital Expenditure	2014/2015 Actual £m	2015/2016 Estimate £m	2016/2017 Estimate £m	2017/2018 Estimate £m	Future years Estimate £m
Total	**101.5**	**153.4**	**114.3**	**110.5**	**92.7**

Source: Cheshire East Finance

3.2 Capital expenditure has been and will be financed or funded as follows:

Capital Financing	2014/2015 Actual £m	2015/2016 Estimate £m	2016/2017 Estimate £m	2017/2018 Estimate £m	Future years Estimate £m
Capital receipts	4.4	17.0	23.0	24.0	20.0
Government Grants	55.7	42.0	50.8	61.3	56.6
External Contributions	9.5	15.8	19.4	6.9	15.7
Revenue Contributions	1.5	3.6	0.2	0.0	0.0
Total Financing	**71.2**	**78.4**	**93.4**	**92.1**	**92.2**
Prudential Borrowing	30.3	75.0	20.9	18.4	0.5
Total Funding	**30.3**	**75.0**	**20.9**	**18.4**	**0.5**
Total Financing and Funding	**101.5**	**153.4**	**114.3**	**110.5**	**92.7**

Source: Cheshire East Finance

4. Ratio of Financing Costs to Net Revenue Stream:

4.1 This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs. The definition of financing costs is set out in the Prudential Code.

4.2 The ratio is based on costs net of investment income.

Ratio of Financing Costs to Net Revenue Stream	2014/2015 Actual %	2015/2016 Estimate %	2016/2017 Estimate %	2017/2018 Estimate %
Total	**4.90**	**5.68**	**5.86**	**6.00**

Source: Cheshire East Finance

5. Capital Financing Requirement:

5.1 The Capital Financing Requirement (CFR) measures the Authority’s underlying need to borrow for a capital purpose. The calculation of the CFR is taken from the amounts held in the Balance Sheet relating to capital expenditure and financing.

Capital Financing Requirement	2014/2015 Actual £m	2015/2016 Estimate £m	2016/2017 Estimate £m	2017/2018 Estimate £m
Total	**229**	**261**	**253**	**260**

Source: Cheshire East Finance

6. Actual External Debt:

6.1 This indicator is obtained directly from the Council's balance sheet. It is the closing balance for actual gross borrowing plus other long-term liabilities. This Indicator is measured in a manner consistent for comparison with the Operational Boundary and Authorised Limit.

Actual External Debt as at 31/03/2015	£m
Borrowing	114
Other Long-term Liabilities	39
Total	**153**

Source: Cheshire East Finance

7. Incremental Impact of Capital Investment Decisions:

7.1 This is an indicator of affordability that shows the impact of capital investment decisions on Council Tax levels. The incremental impact is calculated by comparing the total revenue budget requirement of the current approved capital programme with an equivalent calculation of the revenue budget requirement arising from the proposed capital programme.

Incremental Impact of Capital Investment Decisions	2015/2016 Estimate £	2016/2017 Estimate £	2017/2018 Estimate £
Band D Council Tax	**16.28**	**23.51**	**0**

8. Authorised Limit and Operational Boundary for External Debt:

8.1 The Authority has an integrated treasury management strategy and manages its treasury position in accordance with its approved strategy and practice. Overall borrowing will therefore arise as a consequence of all the financial transactions of the Authority and not just those arising from capital spending reflected in the CFR.

8.2 The **Authorised Limit** sets the maximum level of external debt on a gross basis (i.e. excluding investments) for the Authority. It is measured on a daily basis against all external debt items on the Balance Sheet (i.e. long and short term borrowing, overdrawn bank balances and long term liabilities). This Prudential Indicator separately identifies borrowing from other long term liabilities such as finance leases. It is consistent with the Authority's existing commitments, its proposals for capital expenditure and financing and its approved treasury management policy statement and practices.

8.3 The Authorised Limit is the statutory limit determined under Section 3(1) of the Local Government Act 2003 (referred to in the legislation as the Affordable Limit).

8.4 The Operational Boundary has been set on the estimate of the most likely, i.e. prudent but not worst case scenario with sufficient headroom over and above this to allow for unusual cash movements.

8.5 The Operational Boundary links directly to the Authority's estimates of the CFR and estimates of other cashflow requirements. This indicator is based on the same estimates as the Authorised Limit reflecting the most likely, prudent but not worst case scenario but without the additional headroom included within the Authorised Limit.

	2014/2015 Actual £m	2015/2016 Estimate £m	2016/2017 Estimate £m	2017/2018 Estimate £m
Authorised Limit for Borrowing	239	275	265	270
Authorised Limit for Other Long-Term Liabilities	39	39	38	36
Authorised Limit for External Debt	**278**	**314**	**303**	**306**
Operational Boundary for Borrowing	229	265	255	260
Operational Boundary for Other Long-Term Liabilities	39	39	38	36
Operational Boundary for External Debt	**268**	**304**	**293**	**296**

Source: Cheshire East Finance

9. Adoption of the CIPFA Treasury Management Code:

9.1 This indicator demonstrates that the Authority has adopted the principles of best practice.

Adoption of the CIPFA Code of Practice in Treasury Management
The Council approved the adoption of the CIPFA Treasury Management Code at its Council meeting on 23rd February 2012

The Authority has incorporated the changes from the revised CIPFA Code of Practice into its treasury policies, procedures and practices.

10. Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure:

10.1 These indicators allow the Authority to manage the extent to which it is exposed to changes in interest rates. This Authority calculates these limits on net principal outstanding sums, (i.e. fixed rate debt net of fixed rate investments.

10.2 The upper limit for variable rate exposure has been set to ensure that the Authority is not exposed to interest rate rises which could adversely impact on the revenue budget. The limit allows for the use of variable rate debt to offset exposure to changes in short-term rates on investments

	Existing level (or Benchmark level) at 31/03/2015	2015/2016 Estimate	2016/2017 Estimate	2017/2018 Estimate
		%	%	%
Upper Limit for Fixed Interest Rate Exposure	100%	100%	100%	100%
Upper Limit for Variable Interest Rate Exposure	0%	100%	100%	100%

Source: Cheshire East Finance

10.3 The limits above provide the necessary flexibility within which decisions will be made for drawing down new loans on a fixed or variable rate basis; the decisions will ultimately be determined by expectations of anticipated interest rate movements as set out in the Authority's treasury management strategy.

11. Maturity Structure of Fixed Rate borrowing:

11.1 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 in the course of the next ten years.

11.2 It is calculated as the amount of projected borrowing that is fixed rate maturing in each period as a percentage of total projected borrowing that is fixed rate. The maturity of borrowing is determined by reference to the earliest date on which the lender can require payment.

11.3 LOBOs are classified as maturing on the next call date i.e. the earliest date that the lender can require repayment. As all LOBOs are can be called within 12 months the upper limit for borrowing maturing within 12 months is relatively high to allow for the value of LOBOs and any potential short term borrowing that could be undertaken in 2015/16.

Maturity structure of fixed rate borrowing	Level as at 31st March 2015(based on Current Borrowing) %	Lower Limit for 2015/2016 %	Upper Limit for 2015/2016 %
under 12 months	22%	0%	35%
12 months and within 24 months	5%	0%	25%
24 months and within 5 years	16%	0%	35%
5 years and within 10 years	4%	0%	50%
10 years and within 20 years	23%	0%	100%
20 years and within 30 years	7%	0%	100%
30 years and within 40 years	14%	0%	100%
40 years and within 50 years	9%	0%	100%
50 years and above	0%	0%	100%

12. Credit Risk:

12.1 The Authority considers security, liquidity and yield, in that order, when making investment decisions.

12.2 Credit ratings remain an important element of assessing credit risk, but they are not a sole feature in the Authority's assessment of counterparty credit risk.

12.3 The Authority also considers alternative assessments of credit strength, and information on corporate developments of and market sentiment towards counterparties. The following key tools are used to assess credit risk:

- Published credit ratings of the financial institution (minimum A- or equivalent) and its sovereign (minimum AA+ or equivalent for non-UK sovereigns);
- Sovereign support mechanisms;
- Credit default swaps (where quoted);
- Share prices (where available);
- Economic fundamentals, such as a country's net debt as a percentage of its GDP);
- Corporate developments, news, articles, markets sentiment and momentum;
- Subjective overlay.

12.4 The only indicators with prescriptive values remain to be credit ratings. Other indicators of creditworthiness are considered in relative rather than absolute terms.