Appendix A

Treasury Management Annual Report 2015/16

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 2016 was £34.0m (compared to £47.7m as at 31 March 2015) as follows:

	31/03/15	31/03/16
	£m	£m
GOVERNMENT		
Lancashire County Council	-	2.0
Gloucester Police Crime Commissioner	-	2.0
UK BANKS		
Bank of Scotland (Covered Bond)	-	4.0
Close Bros	-	3.0
Barclays Bank	5.2	0.5
Lloyds TSB	2.0	-
FOREIGN BANKS		
Toronto Dominion (Canada)	-	1.5
Deutsche Bank (Germany)	6.0	-
Svenska Handelsbanken (Sweden)	5.0	-
BUILDING SOCIETIES		
National Counties Building Society	-	1.0
Nationwide Building Society	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	3.9	5.2
Standard Life (formerly IGNIS)	2.5	3.2
CCLA	-	0.5
Morgan Stanley	3.5	-
Aberdeen Asset (formerly Scottish Widows)	1.6	-
CORPORATE BONDS		
Volkswagon Financial Services	-	3.0
Rolls Royce plc	-	0.6
MANAGED FUNDS		
Property Funds	5.0	7.5
TOTAL	**47.7**	**34.0**

There has been a change in the types of investment since last year with more diversification introduced into the portfolio. The property fund, government bodies, covered bonds and most corporate bonds are exempt from the new bank bail-in arrangements.

The net investment income received in 2015/2016 after allowing for fees and interest due to the Growing Places and Local Growth Funds was £0.9m.

The overall average rate of interest on all investments in 2015/16 was 1.09% compared to the benchmark 7 day LIBID average return of 0.45% and our own performance target of 1.00% (Bas Rate + o.50%). 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 2015/16 was £14m which accounts for 6% of the Council's net revenue budget.

We will continue to monitor performance during 2016/17 through the benchmarking service provided by the Council's Treasury Management Advisors, Arlingclose Ltd.

2. Interest Rates and Prospects for 2015/16

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 2015/16

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 Guidance on Local Government

Investments in England gives priority to security and liquidity and the Authority's aim is to achieve a yield commensurate with these principles.

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 a maximum value of £5m (now revised to £6m). 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 (now revised to £12m) per fund. 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 (now revised to £50m in total). Due to their smaller size, unrated Building Societies have a limit of £1m each.

Counterparty update

The transposition of two European Union directives into UK legislation placed the burden of rescuing failing EU banks disproportionately onto unsecured institutional investors which include local authorities and pension funds. During the year, all three credit ratings agencies reviewed their ratings to reflect the loss of government support and the potential for loss given default as a result of new bail-in regimes in many countries. Despite reductions in government support, many institutions saw upgrades due to an improvement in their underlying strength and an assessment that that the level of loss given default is low.

In December the Bank of England released the results of its latest stress tests on the seven largest UK banks and building societies which showed that the Royal Bank of Scotland and Standard Chartered Bank were the weakest performers. However, the regulator did not require either bank to submit revised capital plans, since both firms had already improved their ratios over the year.

The end of bank 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 continues to be elevated relative to other investment options. The Authority, therefore, increasingly favoured secured investment options or diversified alternatives such as covered bonds, non-bank investments and pooled funds over unsecured bank and building society deposits. Of the £34.0m invested at 31st March 2016, £19.1m was placed in these type of investments. These tend to be of a medium to longer term nature so these types of investments are limited by liquidity requirements bearing in mind predicted future cash flows and market availability.

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 and the use of call accounts. The Councils cash resources have an annual cycle dipping in March but with known receipts then due in April. The Council has avoided the need for any new long term borrowing by utilising existing cash resources which has led to lower cash balances. In order to maintain quality of investments throughout March, temporary borrowing of £12m was taken in March for repayment in April.

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 2015/16 the Council invested a further £2.5m in the CCLA property fund bringing the total amount invested up to £7.5m. This 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.

At 31st March 2016 the value (sale price) of the fund was £7,638,711. The fund has steadily increased since the investments were made over and above the costs of investment which is represented by a difference between the purchase price and sale price. Any changes in the underlying capital value of the fund will only be realised when the investments are sold.

The fund pays dividends on a quarterly basis which have averaged 4.97% return on the sum invested during 2015/16. This compares to the rest of the Council's investments, where the average return was 0.67%. The continued use of this fund is being kept under review particularly in light of diminishing cash resources.

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

5. Borrowing strategy

At the end of the year 2015/16 the Council had debt outstanding of £121.2m. Of this £88.9m represented loans from the PWLB, £17m represented loans raised from commercial banks, £12m represented temporary borrowing repaid in April 2016 whilst £3.3m represents interest free loans from Salix repayable within the next 4 years.

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 2015/16

Growth, Inflation, Employment: The UK economy slowed in 2015 with GDP growth falling to 2.3% from a robust 3.0% the year before. CPI inflation hovered around 0.0% through 2015 with deflationary spells in April, September and October. The prolonged spell of low inflation was attributed to the continued collapse in the price of oil from $67 a barrel in May 2015 to just under $28 a barrel in January 2016, the appreciation of sterling since 2013 pushing down import prices and weaker than anticipated wage growth resulting in subdued unit labour costs. CPI picked up to 0.3% year/year in February, but this was still well below the Bank of England's 2% inflation target. The labour market continued to improve through 2015 and in Q1 2016, the latest figures (Jan 2016) showing the employment rate at 74.1% (the highest rate since comparable records began in 1971) and the unemployment rate at a 12 year low of 5.1%. Wage growth has however remained modest at around 2.2% excluding bonuses, but after a long period of negative real wage growth (i.e. after inflation) real earnings were positive and growing at their fastest rate in eight years, boosting consumers' spending power.

Global influences: The slowdown in the Chinese economy became the largest threat to the South East Asian region, particularly on economies with a large trade dependency on China and also to prospects for global growth as a whole. The effect of the Chinese authorities' intervention in their currency and equity markets was temporary and led to high market volatility as a consequence. There were falls in prices of equities and risky assets and a widening in corporate credit spreads. As the global economy entered 2016 there was high uncertainty about growth, the outcome of the US presidential election and the consequences of June's referendum on whether the UK is to remain in the EU. Between February and March 2016 sterling had depreciated by around 3%, a significant proportion of the decline reflecting the uncertainty surrounding the referendum result.

UK Monetary Policy: The Bank of England's MPC (Monetary Policy Committee) made no change to policy, maintaining the Bank Rate at 0.5% (in March it entered its eighth year at 0.5%) and asset purchases (Quantitative Easing) at £375bn. In its *Inflation Reports* and monthly monetary policy meeting minutes, the Bank was at pains to stress and reiterate that when interest rates do begin to rise they were expected to do so more gradually and to a lower level than in recent cycles.

Improvement in household spending, business fixed investment, a strong housing sector and solid employment gains in the US allowed the Federal Reserve to raise rates in December 2015 for the first time in nine years to take the new Federal funds range to 0.25%-0.50%. Despite signalling four further rate hikes in 2016, the Fed chose not to increase rates further in Q1 and markets pared back expectations to no more than two further hikes this year.

However central bankers in the Eurozone, Switzerland, Sweden and Japan were forced to take policy rates into negative territory. The European Central Bank also announced a range of measures to inject sustained economic recovery and boost domestic inflation which included an increase in asset purchases (Quantitative Easing).

Market reaction: From June 2015 gilt yields were driven lower by the a weakening in Chinese growth, the knock-on effects of the fall in its stock market, the continuing fall in the price of oil and commodities and acceptance of diminishing effectiveness of central bankers' unconventional policy actions. Added to this was the heightened uncertainty surrounding the outcome of the UK referendum on its continued membership of the EU as well as the US presidential elections which culminated in significant volatility in equities and corporate bond yields.

7. Prudential Indicators 2015/16

The Council can confirm that it has complied with its Prudential Indicators for 2015/16, approved on 25th February 2015 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 2015/16. 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 2015/16 and revisions to 2016/17 – 2018/19

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 2015/16, 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	2015/2016	2016/2017	2017/2018	2018/19	Future years
	Actual £m	Estimate £m	Estimate £m	Estimate £m	Estimate £m
Total	**90.6**	**201.2**	**138.8**	**93.5**	**72.9**

Source: Cheshire East Finance

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

Capital Financing	2015/2016 Actual £m	2016/2017 Estimate £m	2017/2018 Estimate £m	2018/19 Estimate £m	Future years Estimate £m
Capital receipts	18.4	23.0	24.0	20.0	20.0
Government Grants	27.9	53.5	55.6	69.7	17.5
External Contributions	8.6	9.9	12.5	3.7	35.1
Revenue Contributions	2.1	1.9	0.0	0.0	0.0
Total Financing	**57.0**	**88.3**	**92.1**	**93.5**	**72.6**
Prudential Borrowing	33.6	112.9	46.7	0.0	0.3
Total Funding	**33.6**	**112.9**	**46.7**	**0.0**	**0.3**
Total Financing and Funding	**90.6**	**201.2**	**138.8**	**93.5**	**72.9**

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	2015/2016 Actual %	2016/2017 Estimate %	2017/2018 Estimate %	2018/2019 Estimate %
Total	**5.68**	**5.25**	**5.54**	**5.83**

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 31/03/2016	£m
Borrowing	121
Other Long-term Liabilities	41
Total	**162**

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	2016/2017 Estimate £	2017/2018 Estimate £	2018/2019 Estimate £
Band D Council Tax	**23.51**	**26.72**	**34.63**

Source: Cheshire East Finance

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 cash flow 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.

	2015/2016 Actual £m	2016/2017 Estimate £m	2017/2018 Estimate £m	2018/2019 Estimate £m
Authorised Limit for Borrowing	265	290	355	425
Authorised Limit for Other Long-Term Liabilities	30	39	38	36
Authorised Limit for External Debt	**295**	**329**	**393**	**461**
Operational Boundary for Borrowing	255	280	345	415
Operational Boundary for Other Long-Term Liabilities	30	28	27	25
Operational Boundary for External Debt	**285**	**308**	**372**	**440**

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 31/03/2016	2015/2016 Approved %	2015/2016 Revised %	2016/2017 Estimate %	2017/2018 Estimate %	2018/2019 Estimate %
Upper Limit for Fixed Interest Rate Exposure	100%	100%	100%	100%	100%	100%
Upper Limit for Variable Interest Rate Exposure	0%	100%	100%	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 2016/17.

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.