Appendix A

Treasury Management Annual Report 2016/17

1. 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."

2. Economic events of 2016/17

Economic background: Politically, 2016/17 was an extraordinary twelve month period which defied expectations when the UK voted to leave the European Union and Donald Trump was elected the 45th President of the USA. Uncertainty over the outcome of the US presidential election, the UK's future relationship with the EU and the slowdown witnessed in the Chinese economy in early 2016 all resulted in significant market volatility during the year. Article 50 of the Lisbon Treaty, which sets in motion the 2-year exit period from the EU, was triggered on 29th March 2017.

UK inflation had been subdued in the first half of 2016 as a consequence of weak global price pressures, past movements in sterling and restrained domestic price growth. However the sharp fall in the Sterling exchange rate following the referendum had an impact on import prices which, together with rising energy prices, resulted in CPI rising from 0.3% year on year in April 2016 to 2.3% year on year in March 2017.

In addition to the political fallout, the referendum's outcome also prompted a decline in household, business and investor sentiment. The repercussions on economic growth were judged by the Bank of England to be sufficiently severe to prompt its Monetary Policy Committee (MPC) to cut the Bank Rate to 0.25% in August and embark on further gilt and corporate bond purchases as well as provide cheap funding for banks via the Term Funding Scheme to maintain the supply of credit to the economy. This was the first change to base rates since March 2009.

Despite growth forecasts being downgraded, economic activity was fairly buoyant and GDP grew 0.6%, 0.5% and 0.7% in the second, third and fourth calendar quarters of 2016. The labour market also proved resilient, with the ILO unemployment rate dropping to 4.7% in February, its lowest level in 11 years.

Following a strengthening labour market, in moves that were largely anticipated, the US Federal Reserve increased rates at its meetings in December 2016 and March 2017, taking the target range for official interest rates to between 0.75% and 1.00%.

Financial markets: Following the referendum result, gilt yields fell sharply across the maturity spectrum on the view that Bank Rate would remain extremely low for the foreseeable future. After September there was a reversal in longer-dated gilt yields which moved higher, largely due to the MPC revising its earlier forecast that Bank Rate would be dropping to near 0% by the end of 2016.

After recovering from an initial sharp drop in Q2, equity markets rallied, although displaying some volatility at the beginning of November following the US presidential election result. The FTSE-100 and FTSE All Share indices closed at 7342 and 3996 respectively on 31st March, both up 18% over the year. Commercial property values fell around 5% after the referendum, but had mostly recovered by the end of March.

Money market rates for overnight and one week periods remained low since Bank Rate was cut in August. Rates for 6 and 12 months increased between August and November, only to gradually fall back to August levels in March.

Credit background: Various indicators of credit risk reacted negatively to the result of the referendum on the UK's membership of the European Union. UK bank credit default swaps saw a modest rise but bank share prices fell 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.

Fitch and Standard & Poor's downgraded the UK's sovereign rating to AA. Fitch, S&P and Moody's have a negative outlook on the UK. Moody's has a negative outlook on those banks and building societies that it perceives to be exposed to a more challenging operating environment arising from the 'leave' outcome.

None of the banks on the Authority's lending list failed the stress tests conducted by the European Banking Authority in July and by the Bank of England in November, the latter being designed with more challenging stress scenarios, although Royal Bank of Scotland was one of the weaker banks in both tests. The tests were based on banks' financials as at 31st December 2015, 11 months out of date for most. As part of its creditworthiness research and advice, the Authority's treasury advisor Arlingclose regularly undertakes analysis of relevant ratios - "total loss absorbing capacity" (TLAC) or "minimum requirement for eligible liabilities" (MREL) - to determine whether there would be a bail-in of senior investors, such as local authority unsecured investments, in a stressed scenario.

3. Treasury Year End Position

The amount of investments outstanding at 31st March 2017 was £29.8m (compared to £34.0m as at 31 March 2016) as follows:

	31/03/16	**31/03/17**
	£m	**£m**
GOVERNMENT		
Lancashire County Council	2.0	2.0
Gloucester Police Crime Commissioner	2.0	-
UK BANKS		
Barclays Bank	0.5	0.5
Bank of Scotland (Covered Bond)	4.0	-
Close Bros	3.0	-
FOREIGN BANKS		
Toronto Dominion (Canada)	1.5	-
BUILDING SOCIETIES		

National Counties Building Society	1.0	-
MONEY MARKET FUNDS		
Standard Life	3.2	3.9
Deutsche	-	3.5
Federated Investors	5.2	1.7
CCLA	0.5	0.5
Aberdeen Asset (formerly Scottish Widows)	-	1.7
CORPORATE BONDS		
Volkswagon Financial Services	3.0	-
Rolls Royce plc	0.6	-
MANAGED FUNDS		
Property Funds	7.5	7.5
Federated Investors – Cash Plus Fund (VNAV)	-	7.5
Deutsche – Ultra Short Fund (VNAV)	-	1.0
TOTAL	**34.0**	**29.8**

There has been a change in the types of investment since last year with less diversification in order to maintain liquidity. The Variable Net Asset Value (VNAV) managed funds are available at short notice and generate higher returns than short term fixed deposits or standard money market funds.

The net investment income received in 2016/2017 after allowing for fees and interest due to the Growing Places and Local Growth Funds was £0.5m.

The overall average rate of interest on all investments in 2016/17 was 1.06% compared to the benchmark 7 day LIBID average return of 0.30% and our own performance target of 0.75% (Base Rate + 0.50%). The base rate was reduced from 0.50% to 0.25% in August 2016.

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 2016/17 was £14m which accounts for 6% of the Council's net revenue budget.

We will continue to monitor performance during 2017/18 through the benchmarking service provided by the Council's Treasury Management Advisors, Arlingclose Ltd.

4. 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).

5. Investment Strategy for 2016/17

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 £6m. This limit applies to the banking group that each bank belongs to.

Limits for each Money Market fund have been set at a maximum value of £12m per fund. There is also a maximum that can be invested in all Money Market Funds at any one time of £50m in total. Due to their smaller size, unrated Building Societies have a limit of £1m each.

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. Following the reduction in the UK Bank Base Rate, short term money market rates fell and remained at even lower levels than previous years which continue to have an impact on investment income.

Use of External Fund Managers

In previous years the Council had invested a total of £7.5 in a property fund. 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.

Following the referendum result for the UK to leave the EU, the fund was devalued by 4% in line with general commercial property valuations. This meant the value of the fund dropped from £7.64m as valued in 2015/16 accounts to £7.4m. However, in line with expectations and the general growth of the UK economy the value of the fund has since increased and at 31st March 2017 the value (sale price) of the fund was £7.52m. 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 4.66% return on the sum invested during 2016/17. This compares to the rest of the Council's investments, where the average return was 0.62%. The continued use of this fund is being kept under review particularly in light of diminishing cash resources. However, as the cost of temporary borrowing to cover short term cash shortfalls was only 0.50% it was prudent to maintain this investment as part of our long term strategy.

6. Borrowing strategy

At the end of the year 2016/17 the Council had debt outstanding of £115.5m. Of this £82.9m represented loans from the PWLB, £17m represented loans raised from commercial banks, £12m represented temporary borrowing repaid in April 2017 whilst £3.6m 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.

7. Prudential Indicators 2016/17

The Council can confirm that it has complied with its Prudential Indicators for 2016/17, approved on 25th February 2016 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 2016/17. 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 2016/17 and revisions to 2017/18 – 2019/20

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 2016/17, 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	2016/2017	2017/2018	2018/2019	2019/2020	Future years
	Actual £m	Estimate £m	Estimate £m	Estimate £m	Estimate £m
Total	**78.7**	**116.2**	**135.8**	**61.5**	**19.0**

Source: Cheshire East Finance

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

Capital Financing	2016/2017 Actual £m	2017/2018 Estimate £m	2018/2019 Estimate £m	2019/2020 Estimate £m	Future years Estimate £m
Capital receipts	8.6	10.4	13.1	10.0	7.2
Government Grants	24.4	39.2	105.4	23.2	0.0
External Contributions	4.0	5.5	3.0	27.6	4.9
Revenue Contributions	0.5	0.6	0.0	0.0	0.0
Total Financing	**37.5**	**55.7**	**121.5**	**60.8**	**12.1**
Prudential Borrowing	41.2	60.5	14.3	0.7	6.9
Total Funding	**41.2**	**60.5**	**14.3**	**0.7**	**6.9**
Total Financing and Funding	**78.7**	**116.2**	**135.8**	**61.5**	**19.0**

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	2016/2017 Actual %	2017/2018 Estimate %	2018/2019 Estimate %	2019/2020 Estimate %
Total	**5.60**	**5.67**	**5.59**	**5.60**

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 31/03/2017	£m
Borrowing	116
Other Long-term Liabilities	39
Total	**155**

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	2017/2018 Estimate £	2018/2019 Estimate £	2019/20 Estimate £
Band D Council Tax	**12.15**	**15.17**	**7.3**

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.

	2016/2017 Actual £m	2017/2018 Estimate £m	2018/2019 Estimate £m	2019/2020 Estimate £m
Authorised Limit for Borrowing	250	270	280	310
Authorised Limit for Other Long-Term Liabilities	39	37	35	33
Authorised Limit for External Debt	**289**	**307**	**315**	**343**
Operational Boundary for Borrowing	240	260	275	300
Operational Boundary for Other Long-Term Liabilities	39	37	35	33
Operational Boundary for External Debt	**279**	**297**	**310**	**333**

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 31/03/2017	2016/2017 Approved %	2016/2017 Revised %	2017/2018 Estimate %	2018/2019 Estimate %	2019/2020 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 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 2017/18.

Maturity structure of fixed rate borrowing	Level as at 31st March 2017(based on Current Borrowing) %	Lower Limit for 2017/2018 %	Upper Limit for 2017/2018 %
under 12 months	23%	0%	35%
12 months and within 24 months	6%	0%	25%
24 months and within 5 years	11%	0%	35%
5 years and within 10 years	0%	0%	50%
10 years and within 20 years	26%	0%	100%
20 years and within 30 years	9%	0%	100%
30 years and within 40 years	23%	0%	100%
40 years and within 50 years	3%	0%	100%
50 years and above	0%	0%	100%

Source: Cheshire East Finance

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.