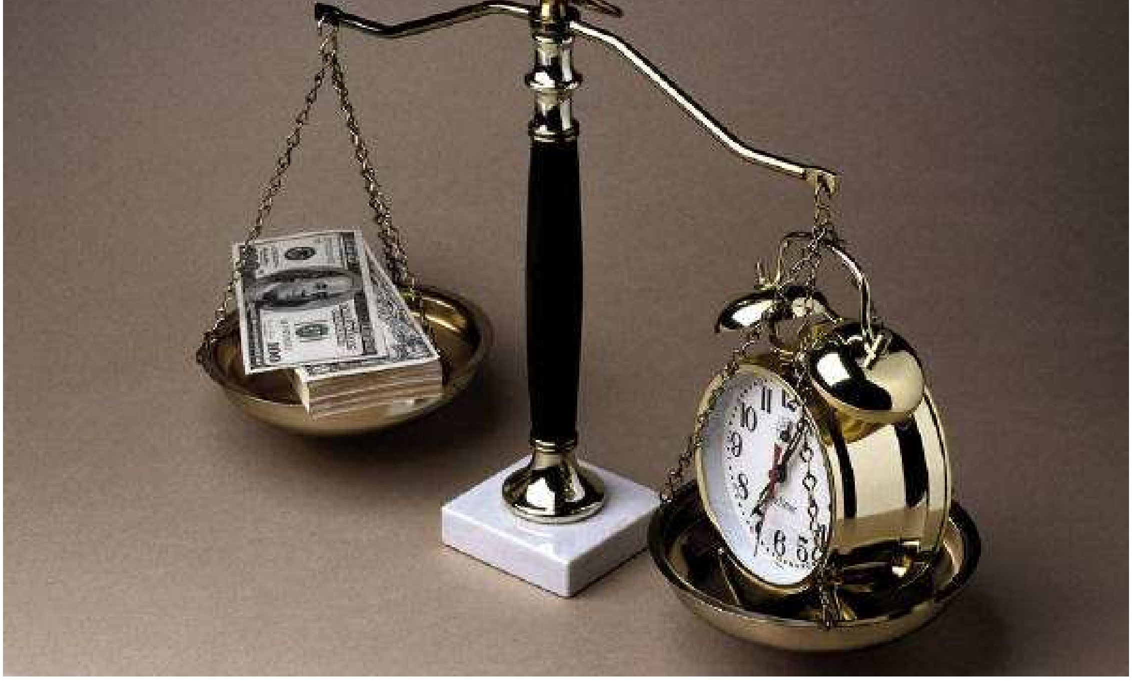
Appendix A

Treasury Management Annual Report 2013/14



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 2014 was £61.1m (compared to £68.5m as at 31 March 2013) as follows:

	31/03/13	31/03/14
	£m	**£m**
BANKS (Fixed and Certificates of Deposit)		
Barclays Bank	-	5.0
Lloyds TSB	6.0	3.0
Close Bros	-	3.0
Standard Chartered Bank	2.0	2.0
Nationwide Building Society	-	2.0
MONEY MARKET FUNDS		
IGNIS	8.5	7.6
Federated Investors	6.5	5.9
Morgan Stanley	-	4.5
Deutsche	3.0	0.9
Scottish Widows	3.9	1.5
INSTANT ACCESS ACCOUNTS		
Santander (UK)	8.5	5.3
Royal Bank of Scotland	5.5	-
Co-op Reserve	1.5	-
NOTICE ACCOUNTS		
Royal Bank of Scotland	3.0	-
MANAGED FUNDS		
Investec – Pooled Funds	20.1	20.4
TOTAL	**68.5**	**61.1**

The net investment income received in 2013/2014 after allowing for fees and interest due to the Growing Places fund was £753,000. This is favourable compared to the budget of £320,000. The investment income includes £335,000 relating to deposits made by the former Cheshire County Council with the Icelandic Heritable Bank which were received in 2013/14.

The overall average rate of interest on all investments in 2013/14 was 0.50% compared to the benchmark 7 day LIBID return of 0.41%. 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 2013/14 was £11.9m which accounts for 4.6% of the Council's total revenue budget. Overall the budget was under spent by £0.9m. As cash balances remained stable throughout the year no additional external borrowing was undertaken, resulting in lower external interest charges than budgeted.

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

2. Icelandic Bank Deposits

Repayment of monies due from Heritable Bank has continued. In August 2011 the administrators announced that we are likely to receive around 88% of the original claim. However, further receipts in 2013/14 have brought the total amount repaid to date to 94% enabling part of the original impairment to be reversed. There is still the possibility of a further receipt dependent on the outcome of legal proceedings currently affecting the entitlement of other parties.

From the total claim of £4.62m we have now received £4.35m (94%).

3. Interest Rates and Prospects for 2013/14

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.

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 8).

5. Investment Strategy for 2013/14

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 minimum long-term counterparty credit rating determined for the 2013/14 treasury strategy was A-/A-/A3 across rating agencies Fitch, S&P and Moody's although unrated Building Societies are now included based on other credit criteria benchmarked to other rated organisations.

In July Moody's placed the A3 long-term ratings of Royal Bank of Scotland and NatWest Bank and the D+ standalone financial strength rating of RBS on review for downgrade amid concerns about the impact of any potential breakup of the bank on creditors. As a precautionary measure the Authority reduced its duration to overnight for new investments with the bank(s). In March Moody's downgraded the long-term ratings of both banks to Baa1. As this rating is below the Authority's minimum credit criterion of A-, the banks were withdrawn from the counterparty list for further investment.

During 2013/14 the Councils banking services were provided by Co-operative Bank. Due to their low credit worthiness and their on-going financial difficulties the Council carefully managed its individual account exposure and did not make any investments with Co-operative Bank. As from 1st April 2014 the Council has transferred its operational bank accounts to Barclays Bank and has subsequently closed all accounts at the Co-operative Bank.

The Financial Services (Banking Reform) Act 2013 gained Royal Assent in December, legislating for the separation of retail and investment banks and for the introduction of mandatory bail-in in the UK to wind up or restructure failing financial institutions. EU finance ministers agreed further steps towards banking union, and the Single Resolution Mechanism (SRM) for resolving problems with troubled large banks which will shift the burden of future restructurings/rescues to the institution’s shareholders, bondholders and unsecured investors. The impact of this on the Treasury Strategy was to reduce the maximum amounts that could be invested in any one counterparty and to diversify the types of investment which will impact on 2014/15 investment activity.

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 continues to have an impact on investment income.

Use of External Fund Managers

In May 2011 the Council placed £20m with Investec in pooled funds, for which the aim is to generate higher returns in a low interest rate environment through investment in a diverse range of instruments. The return on these funds after fees in 2013/14 was 0.19% with an average rate of return since May 2011 of 0.51%.

Whilst volatility is expected, the performance of the fund since we joined is not as good as we originally hoped and has not provided the additional income originally anticipated, As a result, the Council is considering withdrawal of these funds and finding alternative types of investment.

6. Borrowing strategy

At the end of the year 2013/14 the Council had debt outstanding of £125.6m. Of this £17m represented loans raised from commercial banks whilst £108.6m 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.

7. Economic events of 2013/14

At the beginning of the 2013-14 financial year markets were concerned about lacklustre growth in the Eurozone, the UK and Japan. Lack of growth in the UK economy, the threat of a 'triple-dip' alongside falling real wages (i.e. after inflation) and the paucity of business investment were a concern for the Bank of England's Monetary Policy Committee. Only two major economies – the US and Germany – had growth above pre financial crisis levels, albeit these were still below trend. The Eurozone had navigated through a turbulent period for its disparate sovereigns and the likelihood of a near-term disorderly collapse had significantly diminished. The US government had just managed to avoid the fiscal cliff and a technical default in early 2013, only for the problem to re-emerge later in the year.

The Bank of England unveiled forward guidance in August pledging to not consider raising interest rates until the ILO unemployment rate fell below the 7% threshold. In the Bank's initial forecast, this level was only expected to be reached in 2016. Although the Bank stressed that this level was a ***threshold*** for consideration of rate increase rather an automatic trigger, markets began pricing in a much earlier rise than was warranted and, as a result, gilt yields rose aggressively.

The recovery in the UK surprised with strong economic activity and growth. Q4 2014 GDP showed year-on-year growth of 2.7%. Much of the improvement was down to the dominant service sector, and an increase in household consumption buoyed by the pick-up in housing transactions which were driven by higher consumer confidence, greater availability of credit and strengthening house prices which were partly boosted by government initiatives such as Help-to-Buy. However, business investment had yet to recover convincingly and the recovery was not accompanied by meaningful productivity growth. Worries of a housing bubble were tempered by evidence that net mortgage lending was up by only around 1% annually.

CPI fell from 2.8% in March 2013 to 1.7% in February 2014, the lowest rate since October 2009, helped largely by the easing commodity prices and discounting by retailers, reducing the pressure on the Bank to raise rates. Although the fall in unemployment (down from 7.8% in March 2013 to 7.2% in January 2014) was faster than the Bank of England or indeed many analysts had forecast, it hid a stubbornly high level of underemployment. Importantly, average earnings growth remained muted and real wage growth (i.e. after inflation) was negative. In February the Bank stepped back from forward guidance relying on a single indicator – the unemployment rate – to more complex measures which included spare capacity within the economy. The Bank also implied that when official interest rates were raised, the increases would be gradual – this helped underpin the 'low for longer' interest rate outlook despite the momentum in the economy.

The Office of Budget Responsibility's 2.7% forecast for economic growth in 2014 forecast a quicker fall in public borrowing over the next few years.

However, the Chancellor resisted the temptation to spend some of the proceeds of higher economic growth. In his 2013 Autumn Statement and the 2014 Budget, apart from the rise in the personal tax allowance and pension changes, there were no significant giveaways and the coalition's austerity measures remained on track.

Gilt Yields and Money Market Rates: Gilt yields ended the year higher than the start in April. The peak in yields was during autumn 2013. The biggest increase was in 5-year gilt yields which increased by nearly 1.3% from 0.70% to 1.97%. 10-year gilt yields rose by nearly 1% ending the year at 2.73%. The increase was less pronounced for longer dated gilts; 20-year yields rose from 2.74% to 3.37% and 50-year yields rose from 3.23% to 3.44%.
3-month, 6-month and 12-month Libid rates remained at levels below 1% through the year.

8. Prudential Indicators 2013/14

The Council can confirm that it has complied with its Prudential Indicators for 2013/14, which were approved on 28th February 2013 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 2013/14. 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 2013/14 and revisions to 2014/15 – 2016/17

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 2013/14, 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	2013/2014	2014/2015	2015/2016	2016/2017	Future years
	Actual	Estimate	Estimate	Estimate	Estimate
	£m	£m	£m	£m	£m
Total	**65.6**	**147.8**	**102.6**	**77.7**	**120.9**

Source: Cheshire East Finance

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

Capital Financing	2013/2014 Actual £m	2014/2015 Estimate £m	2015/2016 Estimate £m	2016/2017 Estimate £m	Future years Estimate £m
Capital receipts	5.5	32.9	22.4	31.4	23.7
Government Grants	34.9	76.8	18.6	31.6	85.3
External Contributions	2.5	14.0	14.8	6.6	11.9
Revenue Contributions	0.9	4.2	1.2	0.2	0
Total Financing	**43.8**	**127.9**	**57.0**	**69.8**	**120.9**
Prudential Borrowing	21.8	19.9	45.6	7.9	0
Total Funding	**21.8**	**19.9**	**45.6**	**7.9**	**0.0**
Total Financing and Funding	**65.6**	**147.8**	**102.6**	**77.7**	**120.9**

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	2013/2014 Actual %	2014/2015 Estimate %	2015/2016 Estimate %	2016/2017 Estimate %
Total	**4.23**	**4.93**	**5.76**	**5.98**

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	2013/2014 Actual £m	2014/2015 Estimate £m	2015/2016 Estimate £m	2016/2017 Estimate £m
Total	**205**	**234**	**242**	**222**

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 31/03/2014	£m
Borrowing	126
Other Long-term Liabilities	39
Total	**165**

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	2014/2015 Estimate £	2015/2016 Estimate £	2016/2017 Estimate £
Band D Council Tax	**4.38**	**10.94**	**0**

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 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.

	2013/2014 Actual £m	2014/2015 Estimate £m	2015/2016 Estimate £m	2016/2017 Estimate £m
Authorised Limit for Borrowing	212	245	255	265
Authorised Limit for Other Long-Term Liabilities	26	24	23	22
Authorised Limit for External Debt	**238**	**269**	**278**	**287**
Operational Boundary for Borrowing	202	235	245	255
Operational Boundary for Other Long-Term Liabilities	26	24	23	22
Operational Boundary for External Debt	**228**	**259**	**268**	**277**

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

	(or Benchmark level) at 31/03/14 %	Estimate %	Estimate %	Estimate %
Upper Limit for Fixed Interest Rate Exposure	100%	100%	100%	100%
Upper Limit for Variable Interest Rate Exposure	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 2014/15.

Maturity structure of fixed rate borrowing	Level as at 31st March 2014 %	Lower Limit for 2014/2015 %	Upper Limit for 2014/2015 %
under 12 months	22%	0%	35%
12 months and within 24 months	7%	0%	25%
24 months and within 5 years	14%	0%	35%
5 years and within 10 years	9%	0%	50%
10 years and within 20 years	19%	0%	100%
20 years and within 30 years	8%	0%	100%
30 years and within 40 years	13%	0%	100%
40 years and within 50 years	8%	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.