Appendix 7

Treasury Management Annual Report 2018/19

1. Introduction

1.1 In February 2018 the Authority adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the Authority to approve treasury management semi-annual and annual reports.

1.2 The Authority's treasury management strategy for 2018/19 was approved at a meeting of the Council on 22nd February 2018. The Authority has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk remains central to the Authority's treasury management strategy.

1.3 Treasury risk management at the Authority is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) which requires the Authority to approve a treasury management strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report. This report fulfils the Authority's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

1.4 The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Authority's Capital Strategy, complying with CIPFA's requirement, was approved by full Council on 21st February 2019.

2. Economic events of 2018/19

2.1 **Economic background:** After spiking at over $85/barrel in October 2018, oil prices fell back sharply by the end of the year, declining to just over $50 in late December before steadily climbing toward $70 in April 2019. UK Consumer Price Inflation (CPI) for February 2019 was up 1.9% year/year, just above the consensus forecast but broadly in line with the Bank of England's February Inflation Report. The most recent labour market data for the three months to January 2019 showed the unemployment rate fell to a new low 3.9% while the employment rate of 76.1% was the highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.4% as wages continue to rise steadily and provide some upward pressure on general inflation. Once adjusted for inflation, real wages were up 1.4%.

2.2 After rising to 0.6% in the third calendar quarter from 0.4% in the second, fourth quarter economic growth slowed to 0.2% as weaker expansion in production, construction and services dragged on overall activity. Annual GDP growth at 1.4% continues to remain below trend. Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy have been made since.

2.3 The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the 2.25%-2.50% range in December. However, a recent softening in US data caused the Fed to signal a pause in hiking interest rates at the last Federal Open Market Committee (FOMC) meeting in March.

2.4 With the 29th March 2019, the original EU ‘exit day’ now been and gone, having failed to pass a number of meaningful votes in Parliament, including rejecting Theresa May’s deal for the third time, MPs voted by a majority of one (313 to 312) to force the prime minister to ask for an extension to the Brexit process beyond 12th April in order to avoid a no-deal scenario. Recent talks between the Conservative and Labour parties to try to reach common ground on a deal which may pass a vote by MPs have yet to yield any positive results. The EU must grant any extension and its leaders have been clear that the terms of the deal are not up for further negotiation. The ongoing uncertainty continues to weigh on sterling and UK markets.

2.5 While the domestic focus has been on Brexit’s potential impact on the UK economy, globally the first quarter of 2019 has been overshadowed by a gathering level of broader based economic uncertainty. The US continues to be set on a path of protectionist trade policies and tensions with China in particular, but with the potential for this to spill over into wider trade relationships, most notably with EU. The EU itself appeared to be show signs of a rapid slowdown in economic growth with the major engines of its economy, Germany and France, both suffering misfires from downturns in manufacturing alongside continued domestic/populist unrest in France. The International Monetary Fund downgraded its forecasts for global economic growth in 2019 and beyond as a consequence.

2.6 **Financial markets:** December was a month to forget in terms of performance of riskier asset classes, most notably equities. The FTSE 100 (a good indicator of global corporate sentiment) returned -8.8% assuming dividends were reinvested; in pure price terms it fell around 13%. However, since the beginning of 2019 markets have rallied, and the FTSE 100 and FTSE All share indices were both around 10% higher than at the end of 2018.

2.7 Gilt yields continued to display significant volatility over the period on the back of ongoing economic and political uncertainty in the UK and Europe. After rising in October, gilts regained their safe-haven status throughout December and into the new year - the 5-year benchmark gilt yield fell as low as 0.80% and there were similar falls in the 10-year and 20-year gilts over the same period dropping from 1.73% to 1.08% and from 1.90% to 1.55%. The increase in Bank Rate pushed up money markets rates over the year and 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.53%, 0.67% and 0.94% respectively over the period.

2.8 Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth is not just a UK phenomenon but a global risk. During March the US yield curve inverted (10-year Treasury yields were lower than US 3 month money market rates) and German 10-year Bund yields turned negative. The drivers are a significant shift in global economic growth prospects and subsequent official interest rate expectations given its impact on inflation expectations. Further to this is world trade growth which collapsed at the end of 2018 falling by 1.8% year-on-year. A large proportion of this downturn in trade can be ascribed to the ongoing trade tensions between the US and China which despite some moderation in January does suggest that the International Monetary Fund's (IMF) and Organisation for Economic Co-Operation & Development's (OECD) forecasts for global growth in 2019 of 3.5% might need to be revised downwards.

2.9 **Credit background:** Credit Default Swap (CDS) spreads, which act as a measure of risk, drifted up towards the end of 2018 on the back of Brexit uncertainty before declining again in 2019 and continuing to remain low in historical terms. After hitting around 129 basis points in December 2018, the spread on non-ringfenced bank NatWest Markets plc fell back to around 96bps at the end of March, while for the ringfenced entity, National Westminster Bank plc, the CDS spread held relatively steady around 40bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 33 and 79bps at the end of the period.

2.10 The ringfencing of the big four UK banks (Barclays, Bank of Scotland/Lloyds, HSBC and RBS/Natwest Bank plc) has been completed transferring their business lines into retail (ringfenced) and investment banking (non-ringfenced) entities.

2.11 In February, Fitch put the UK AA sovereign long-term rating on Rating Watch Negative as a result of Brexit uncertainty. This was followed with the same treatment for UK banks and a number of government-related entities.

2.12 There were minimal other credit rating changes during the period. Moody's revised the outlook on Santander UK to positive from stable to reflect the bank's expected issuance plans which will provide additional protection for the its senior unsecured debt and deposits.

3. Local Context

3.1 On 31st March 2019, the Authority had net borrowings of £17m arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31.3.19 Actual £m
General Fund CFR	330
Less: *Other debt liabilities	24
Borrowing CFR	**354**
External borrowing	(158)
Internal borrowing	**196**
Less: Usable reserves	(112)
Less: Working capital	(67)
Net borrowings	**17**

* finance leases and PFI liabilities that form part of the Authority's total debt

3.2 The Authority pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

3.3 The treasury management position at 31st March 2019 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.18 Balance £m	Movement £m	31.3.19 Balance £m	31.3.19 Rate %
Long-term borrowing	(110)	6	(104)	4.13
Short-term borrowing	(60)	6	(54)	1.99
Total borrowing	**(170)**	**12**	**(158)**	**3.41**
Long-term investments	10	0	10	4.56
Short-term investments	12	(8)	4	0.80
Cash and cash equivalents	2	12	14	0.79
Total investments	**24**	**4**	**28**	**2.14**
Net borrowing	**(146)**	**16**	**(130)**	

4. Borrowing Strategy during the year

4.1 At 31st March 2019 the Authority held £158m of loans (a decrease of £11m from 31st March 2018), as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 31st March are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.18 Balance £m	Net Movement £m	31.3.19 Balance £m	31.3.19 Weighted Average Rate %	31.3.19 Weighted Average Maturity (years)
Public Works Loan Board	77	(6)	71	4.10	20.0
Banks (LOBO)	17	-	17	4.63	27.3
Salix – Energy Efficiency loans	4	(1)	3	0.00	1.6
Local authorities (long-term)	19	1	20	1.17	1.1
Local authorities (short-term)	53	(6)	47	0.82	0.2
Total borrowing	**170**	**(12)**	**158**	**2.73**	**12.2**

4.2 The Authority's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Authority's long-term plans change being a secondary objective.

4.3 With short-term interest rates remaining much lower than long-term rates, the Authority considered it to be more cost effective in the near term to use internal resources and borrow rolling temporary loans on the inter-Local Authority market instead. The net movement in temporary loans is shown in table 3 above.

4.4 The Authority has an increasing CFR due to the capital programme and an estimated borrowing requirement as determined by the Liability Benchmark which also takes into account usable reserves and working capital. In order to ensure borrowing is more reflective of the risks associated with long term spending and to provider longer term certainty and stability to the debt portfolio, a review of alternative borrowing options will be considered in 2019/20.

4.5 LOBO loans: The Authority continues to hold £17m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during the year.

5. Treasury Investment Activity

5.1 The Authority held £28m of invested funds at 31st March 2019, representing income received in advance of expenditure plus balances and reserves held. During the year, the Authority's investment balances ranged between £11m and £45m due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.3.18 Balance £m	Net Movement £m	31.3.19 Balance £m	31.3.19 Income Return %	31.3.19 Weighted Average Maturity (days)
Banks (unsecured)	0.7	(0.7)	-	-	-
Government inc LA's	11.6	(7.6)	4.0	0.80	8
Money Market Funds	1.5	12.6	14.1	0.79	1
Other Pooled Funds:					
- Property funds	7.5	-	7.5	4.62	-
- Cash plus funds	2.5	(2.5)	-	-	-
- Multi asset income funds	-	2.5	2.5	4.39	-
Total investments	**23.8**	**4.3**	**28.1**	**2.14**	**2**

**Weighted average maturity will not apply to property and multi-asset funds as the underlying assets have no pre-determined maturity date.*

5.2 A full list of organisations in which the Council had treasury investments is shown in Table 5.

Table 5: Treasury Investments

	31/03/18	31/03/19
	£m	**£m**
GOVERNMENT		
West Yorkshire Police Crime Commissioner	-	4.0
Central Bedfordshire Council	6.6	-
Surrey Heath District Council	5.0	-
UK BANKS		
Barclays Bank	0.7	-
MONEY MARKET FUNDS		
Federated Investors	-	6.9
Aberdeen Asset (formerly Scottish Widows)	-	5.7
Deutsche	0.5	1.0
CCLA	0.5	0.5
Standard Life	0.5	-
MANAGED FUNDS		
Property Funds	7.5	7.5
Kames – Multi Asset Income Fund	-	2.5
Royal London – Enhanced Cash Fund	2.5	-
TOTAL	**23.8**	**28.1**

5.3 Both the CIPFA Code and government guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

5.4 Given the increasing risk and low returns from unsecured bank deposits the Council has continued to invest short term funds in Money Market Funds which spreads the risk, and where cash flow allows, with other Local Authorities. A strategic long term investment level of £10m has been maintained in order to generate enhanced income whilst diversifying risk. During 2018/19 the Council redeemed it's investment with Royal London Enhanced Cash Plus Fund and invested into the Kames Multi asset fund instead. Whilst the value of the underlying investment may vary, the fund provides increased income returns (4.39% compared to 0.90% for the Royal London Fund). The average income return in 2018/19 was 1.75% compared to 1.55% in 2017/18.

5.5 The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 6 below.

Table 6: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2018	3.81	AA-	16%	6	0.56%
31.03.2019	4.40	AA-	78%	3	0.79%
Similar LAs	**4.17**	**AA-**	**58%**	**50**	**0.84%**
All LAs	**4.20**	**AA-**	**55%**	**29**	**0.85%**

5.6 £10m of the Authority's investments are held in externally managed strategic pooled funds where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. These funds generated a total return of £640.000 (7.30%), comprising a £406,000 (4.56%) income return which is used to support services in year, and £234m (2.74%) of capital growth.

5.7 Strategic funds have no defined maturity date, but are available for withdrawal after a notice period. For this reason their performance and continued suitability in meeting the Authority's investment objectives is regularly reviewed. Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters and even years; but with the confidence that over a three to five-year period total returns will exceed cash interest rates. In light of their performance over the medium / long-term and the Authority's latest cash flow forecasts, overall investment levels in these funds has been maintained.

5.8 Readiness for Brexit: With little by way of political clarity as to the exact date on whether there would be an agreed deal prior to leaving the EU and to be prepared for the outside chance of a particularly disruptive Brexit (such as last-minute no-deal) on 29th March, the Authority ensured there were enough accounts open at UK-domiciled banks and Money Market Funds to hold sufficient liquidity over the year end and that its account with the Debt Management Account Deposit Facility (DMADF) remained available for use in an emergency.

6. Non-treasury Investments

6.1 The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

6.2 As at 31st March 2019 the following non-treasury investments were held.

Table 7: Non-treasury Investments

Counterparty	**Type**	**Original Investment £000***	**Fair Value 31.03.18 £000**	**Fair Value 31.03.19 £000**
Alderley Park Ltd	Equity	1,070	2,400	3,880
Manchester Science Partnerships Ltd	Equity	739	1,604	2,072
GM & Cheshire Life Sciences Fund	Pooled Fund	2,923	2,146	3,053
Alderley Park Ltd	Loan	1,531	1,282	1,290
Cheshire Green Employment Park	Loan	1,264	-	1,213
Everybody Sport & Recreation Ltd	Loan	664	288	643
Engenie Ltd	Loan	24	24	23
Cheshire Neighbours Credit Union	Loan	15	-	-
Total Value		**8,230**	**7,744**	**12,174**

* *Original investment for loans represents the outstanding principal as at 31/03/19*

6.3 During the year the Council made new loans to Everybody Sport & Recreation and Cheshire Neighbours Credit Union. The loan to Cheshire Green Employment Park is arranged through the Local Enterprise Partnership, Growing Places Fund but with the Council as the loan provider. The fair values at 31/03/19 include an allowance for expected credit losses.

7. Compliance

7.1 All treasury management activities undertaken during the year complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy. Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 8 below and compliance with specific investment limits is demonstrated in table 9 below.

Table 8: Debt Limits

	2018/19 Maximum	31.3.19 Actual	2018/19 Operational Boundary	2018/19 Authorised Limit	Complied?
Borrowing	170	158	390	400	Yes
PFI and Finance Leases	25	24	25	25	Yes
Total debt	**195**	**182**	**415**	**425**	Yes

7.2 Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure. However, there were no such occurrences during 2018/19.

Table 9: Investment Limits

	2018/19 Maximum	31.3.19 Actual	2018/19 Limit	Complied?
Any single organisation, except the UK Government	£6.9m	-	£12m	Yes
Any group of organisations under the same ownership	£6.9m	-	£12m	Yes
Any group of pooled funds under the same management	£10.2m	£8.0m	£25m	Yes
Negotiable instruments held in a broker's nominee account	-	-	£25m	Yes
Limit per non-UK country	-	-	£12m	Yes
Registered providers	-	-	£25m	Yes
Unsecured investments with building societies	-	-	£12m	Yes
Loans to unrated corporates	-	-	£12m	Yes
Money Market Funds	£34.8m	£14m	£50m (£12m per fund)	Yes

8. Treasury Management Indicators

8.1 The Authority measures and manages its exposures to treasury management risks using the following indicators.

8.2 **Security:** The Authority has not adopted a specific measure of its exposure to credit risk. However, the credit quality of all counterparties is kept under continual review. No investments were made with any organisation if there were substantive doubts about its credit quality, even though it may otherwise meet the Councils investment criteria.

8.3 **Liquidity:** The Authority has not adopted a specific measure of its exposure to liquidity risk. However, a cash flow forecasting model is maintained to determine the maximum period for which funds may prudently be committed and to plan appropriately.

8.4 **Interest rate Exposure:** This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of the net principal borrowed was:

Table 10: Interest Rate Exposure

	31.3.19 Actual	2018/19 Limit	Complied?
Upper limit on fixed interest rate exposure	57%	100%	Yes
Upper limit on variable interest rate exposure	43%	100%	Yes

8.5 **Maturity Structure of Borrowing:** This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

Table 11: Maturity Structure of Borrowing

	31.3.19 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	45%	50%	0%	Yes
12 months and within 24 months	15%	25%	0%	Yes
24 months and within 5 years	2%	35%	0%	Yes
5 years and within 10 years	2%	50%	0%	Yes
10 years and within 20 years	14%	100%	0%	Yes
20 years and above	22%	100%	0%	Yes

Note – LOBO loans are treated as maturing in under 12 months as the Council would repay if the lender exercised their option to vary the interest rate.

8.6 **Principal Sums Invested for Periods Longer than 364 days:** The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

Table 12: Principal Investment Limits Longer than 364 Days

	2018/19	2019/20	2019/21
Actual principal invested beyond year end	-	-	-
Limit on principal invested beyond year end	£25m	£15m	£10m
Complied?	Yes	Yes	Yes