APPENDIX 1

Annual Treasury Management Report 2015/16

Purpose

This Council is required through regulations issued under the Local Government Act 2003 to produce an annual treasury report reviewing treasury management activities and the actual prudential and treasury indicators for 2015/16. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

During 2015/16 the minimum reporting requirements were that full Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 23/2/2015)
- a mid year treasury update report (Accounts, Audit & Risk Committee 02/12/15)
- an annual review following the end of the year describing the activity compared to the strategy (this report)

The Accounts, Audit and Risk Committee has been nominated to scrutinise the treasury activity of the Council and it receives regular reports. In addition, this Council has received quarterly treasury management update reports by the Executive.

Recent changes in the regulatory environment place a much greater onus on members for the review and scrutiny of treasury management policy and activities. This report is important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

This Council also confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Accounts, Audit & Risk Committee before they were reported to the full Council.

Executive Summary

During 2015/16, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

Prudential and treasury indicators	**2014/15 Actual £000**	**2015/16 Actual £000**
Capital expenditure	18,185	17,424
Capital Financing Requirement:	(18,185)	(17,424)
Net borrowing	0	0
External debt	0	0
Investments • Longer than 1 year • Under 1 year • Total	 0 49,853 **49,853**	 1,750 36,580 **38,330**

Other prudential and treasury indicators calculated at the time of preparing our Treasury Strategy for 2015/16 are to be found in Annex 1 of this report.

The financial year 2015/16 continued the challenging investment environment of previous years, namely low investment returns and continuing heightened levels of counterparty risk.

Introduction and Background

This report summarises:

- Capital activity during the year;
- Impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement);
- Reporting of the required prudential and treasury indicators;
- Overall treasury position identifying the impact on investment balances;
- Summary of interest rate movements in the year;
- Detailed investment activity.

1. The Council's Capital Expenditure and Financing 2015/16

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed:

	2014/15 Actual £000	**2015/16 Actual £000**
Capital Expenditure	18,185	17,424
Total Capital expenditure	**18,185**	**17,424**
Resourced by		
Capital receipts	(17,762)	(16,962)
Government Grants & Other Contributions	(389)	(462)
Use of Reserves	(34)	-
Direct Revenue Financing	-	-
Total resources used	**18,185**	**17,424**

2. The Council's Overall Borrowing Need

The Council is debt free and does not currently have a borrowing requirement (but see also para 9 for future requirements).

3. Treasury Position as at 31 March 2016

The Council's investment position is organised by the treasury management team in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through Member reporting detailed in the summary, and through officer activity detailed in the Council's Treasury Management Practices. At the beginning and the end of 2015/16 the Council's treasury position was as follows:

	2015/16 Actual £000	**2015/16 Actual £000**
Investments		
Longer than 1 year	0	1,750
Under 1 year	49,853	36,580
Total	**49,853**	**38,330**

4. The Strategy for 2015/16

The Treasury Management Strategy Statement (TMSS) for 2015/16, which includes the Annual Investment Strategy, was approved by the Council on 23/2/2015. It sets out the Council's investment priorities as being:

- **Security of capital;**
- **Liquidity; and**
- **Yield**

The Council will also aim to achieve the optimum return (yield) on investments commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover short term cash flow needs but also to seek out value available in significantly higher rates in periods up to 12 months with highly credit rated financial institutions, using Capita Asset Services suggested creditworthiness approach, including sovereign credit rating and Credit Default Swap (CDS) overlay information provided by Capita.

5. The Economy – 2015/16 overview provided by Capita Asset Services

Market expectations for the first increase in Bank Rate moved considerably during 2015/16, starting at quarter 3 2015 but soon moving back to quarter 1 2016. However, by the end of the year, market expectations had moved back radically to quarter 2 2018 due to many fears including concerns that China's economic growth could be heading towards a hard landing; the potential destabilisation of some emerging market countries particularly exposed to the Chinese economic slowdown; and the continuation of the collapse in oil prices during 2015 together with continuing Eurozone growth uncertainties.

These concerns have caused sharp market volatility in equity prices during the year with corresponding impacts on bond prices and bond yields due to safe haven flows. Bank Rate, therefore, remained unchanged at 0.5% for the seventh successive year. Economic growth (GDP) in the UK surged strongly during both 2013/14 and 2014/15 to make the UK the top performing advanced economy in 2014. However, 2015 has been disappointing with growth falling steadily from an annual rate of 2.9% in quarter 1 2015 to 2.1% in quarter 4.

The Funding for Lending Scheme, announced in July 2012, resulted in a flood of cheap credit being made available to banks which then resulted in money market investment rates falling materially. These rates continued at very low levels during 2015/16.

The sharp volatility in equity markets during the year was reflected in sharp volatility in bond yields. However, the overall dominant trend in bond yields since July 2015 has been for yields to fall to historically low levels as forecasts for inflation have repeatedly been revised downwards and expectations of increases in central rates have been pushed back. In addition, a notable trend in the year was that several central banks introduced negative interest rates as a measure to stimulate the creation of credit and hence economic growth.

The ECB had announced in January 2015 that it would undertake a full blown quantitative easing programme of purchases of Eurozone government and other bonds starting in March at €60bn per month. This put downward pressure on Eurozone bond yields. There was a further increase in this programme of QE in December 2015. The anti-austerity government in Greece, elected in January 2015 eventually agreed to implement an acceptable programme of cuts to meet EU demands after causing major fears of a breakup of the Eurozone. Nevertheless, there are continuing concerns that a Greek exit has only been delayed.

As for America, the economy has continued to grow healthily on the back of resilient consumer demand. The first increase in the central rate occurred in December 2015 since when there has been a return to caution as to the speed of further increases due to concerns around the risks to world growth.

On the international scene, concerns have increased about the slowing of the Chinese economy and also its potential vulnerability to both the bursting of a property bubble and major exposure of its banking system to bad debts. The Japanese economy has also suffered disappointing growth in this financial year despite a huge programme of quantitative easing, while two of the major emerging market economies, Russia and Brazil, are in recession. The situations in Ukraine, and in the Middle East with ISIS, have also contributed to volatility.

The UK elected a majority Conservative Government in May 2015, removing one potential concern but introducing another due to the promise of a referendum on the UK remaining part of the EU. The government maintained its tight fiscal policy stance but the more recent downturn in expectations for economic growth has made it more difficult to return the public sector net borrowing to a balanced annual position within the period of this parliament.

6. Interest rate forecast and economic outlook

The Council's treasury advisor, Capita Asset Services, undertook a review of its interest rate forecasts following the EU Referendum in June 2016. The latest forecast issued on 4 July, shown below, now includes a decrease in the official rate to 0.25% by September 2016, rising back to the current level of 0.5% by the middle of 2018. This is likely to have a corresponding effect on investment and borrowing rates. However, they did point out the huge difficulty in current forecasting due to the large number of unknowns and external factors.

	NOW	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-19
BANK RATE	0.50	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50
3 month LIBID	0.50	0.30	0.30	0.30	0.30	0.30	0.40	0.50	0.50	0.60	0.60	0.60	0.60
6 month LIBID	0.55	0.50	0.50	0.50	0.50	0.60	0.60	0.70	0.70	0.70	0.70	0.70	0.70
12 month LIBID	0.75	0.60	0.60	0.60	0.60	0.70	0.80	0.90	0.90	0.90	0.90	0.90	0.90
5 yr PWLB	1.20	1.00	1.10	1.10	1.10	1.10	1.10	1.10	1.20	1.20	1.20	1.30	1.30
10 yr PWLB	1.70	1.60	1.60	1.60	1.70	1.70	1.70	1.70	1.80	1.80	1.80	1.80	1.90
25 yr PWLB	2.50	2.40	2.40	2.40	2.50	2.50	2.50	2.50	2.60	2.60	2.60	2.70	2.70
50 yr PWLB	2.20	2.20	2.20	2.20	2.30	2.30	2.30	2.30	2.40	2.40	2.40	2.50	2.50

Following the Brexit vote it was initially expected that the resulting economic slowdown in the UK would result in a reduction in public sector spending. Balancing the budget by 2020 was the cornerstone of the government's economic policy and this could, therefore, lead to additional cuts in public spending including local government.

However, the Chancellor's announcement on 1 July 2016 suggests that government policy for the remainder of the parliament will be to allow a fiscal deficit to develop if there is an economic slowdown. The Treasury's fiscal rules allow the government to run a deficit in "exceptional times". It is possible to infer from this announcement that further cuts in public spending are unlikely, at least until 2020.

Clearly this all comes with a massive health warning: the government is only starting to formulate its policy responses to Brexit. Future policy decisions will depend on who is the next prime minister, and future economic conditions might be different from forecasts

7. Investment Outturn for 2015/16

Investment Policy – the Council's investment policy is governed by CLG guidance, which was been implemented in the annual investment strategy approved by the Council on 23/02/2015. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.).

The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

Investments held by fund managers

In 2013/14 the Council decided to recall the monies managed by Investec and all funds have been managed in house since then.

The actual return on investments for 2015/16 was £354k compared with a budget requirement of nil, a positive variance of £354k. However approximately £76k of the interest received is in respect of the investment of Eco Town funds and this has been allocated back to the Eco Town funding pot.

8. Icelandic Bank Defaults

The Council was one of over 100 local authorities that were affected by the collapse of Icelandic banking institutions. The Council held a total of £6,500,000 in 3 investments with Glitnir.

As reported previously out of the £6,500,000 original capital investment £5,771,000 has been returned to the Council. The remaining balance of £729,000 and the associated interest relating to the investment are still held within Iceland but are accruing interest on an annual basis. The carrying value of the investment in GBP including accrued interest at 31 March 2016 was £1,741,000 (31 March 2015 £1,468,000).

Following a decision by the Icelandic Parliament on 22nd May 2016, a further debt auction was held with the Central Bank of Iceland. Cherwell District Council opted to place its entire deposit of £1,741,000 into the auction held on 16th June 2016. The full details are shown in Appendix 2

9. Future Lending/Borrowing

As can be seen in the capital expenditure section in Annex 1 below, spending commitments such as Graven Hill, Build!/Local Housing Company and other Capital Programmes over the next few years may exhaust current reserves and require the Council to borrow, possibly as early as 2017/18.

We are therefore taking advice from Capita Asset Services, tracking PWLB lending rates and monitoring the general economic outlook, so that we are well prepared. Depending on economic conditions and timing, it may be advantageous to borrow earlier than required in order secure the best available rates.

Annex 1 Prudential and Treasury Indicators

Investment & Debt Portfolio Position

	31/03/16 Actual Portfolio £000
External Borrowing:	
- Total External Borrowing	0
Other Long Term Liabilities:	
- Finance Leases	0
Total Gross External Debt	**0**
Investments:	
Managed in-house	
- Short-term monies (Deposits/ monies on call / MMFs)	36,580
- Long-term investments	1,750
Managed externally	
- By Fund Managers	0
- Pooled Funds (please list)	0
Total Investments	**38,330**

Background:

It 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.

Net Borrowing and the Capital Financing Requirement:

This is a key indicator of prudence. In order to ensure that over the medium-term net borrowing will only be for a capital purposes, the local authority needs to ensure that the net external borrowing does not (except in the short term) exceed the total of the capital financing requirement in the preceding year plus the estimates of any additional increases to the capital financing requirement for the current and next two financial years.

The Chief Finance Officer reports that the authority had no difficulty meeting this requirement in 2015/16, nor is there any difficulties envisaged for future years. This view takes into account current commitments, existing plans and the proposals in the approved budget.

Estimates of Capital Expenditure:

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

The Council's capital expenditure plans are summarised below and this forms the first of the prudential indicators. This total expenditure can be paid for immediately by resources such as capital receipts, capital grants etc. However, where these resources are insufficient any residual expenditure will form a borrowing need.

	2015/16 Actual £000s	**2016/17 Estimated £000s**	**2017/18 Estimated £000s**	**2018/19 Estimated £000s**
Capital Expenditure	17,424	30,329	2,441	2,252
Financed by:				
Capital receipts	(16,962)	(4,854)	(2,066)	(1,877)
Capital grants	(462)	(375)	(375)	(375)
Reserves funded through Revenue	0	0	0	0
External Funding	0	0	0	0
Net financing need for the year	0	25,100	0	0

Ratio of Financing Costs to Net Revenue Stream:

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.

The ratio is based on costs net of investment income.

Ratio of Financing Costs to Net Revenue Stream	**2014-15 Actual %**	**2015-16 Estimate %**	**2016-17 Estimate %**	**2017-18 Estimate %**
Total	**-2.25**	**-2.57**	**2.29**	**6.29**

Capital Financing Requirement:

The CFR is simply the total outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of Council's underlying borrowing need.

The Council is required to pay off an element of the accumulated General Fund capital spend each year through a revenue charge (the Minimum Revenue Provision), although it is also allowed to undertake additional voluntary payments.

£'000	2014/15 Actual	2015/16 Actual	2016-17 Estimate	2017/18 Estimate	2018/19 Estimate
Capital Financing Requirement					
Total CFR	**-5,862**	**0**	**25,100**	**0**	**0**
Movement in CFR	**-2,710**	**5,862**	**25,100**	**-25,100**	**0**
Movement in CFR represented by					
Net financing need for the year (above)	-2,710	5,862	25,100	-25,100	0
Less MRP/VRP and other financing movements	0	0	0	0	0
Movement in CFR	**-2,710**	**5,862**	**25,100**	**-25,100**	**0**

Actual External Debt:

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	0
Other Long-term Liabilities	0
Total	**0**

Incremental Impact of Capital Investment Decisions:

This is an indicator of affordability that shows the impact of capital investment decisions on the Council Tax. 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.

This reflects the fact that capital expenditure is predominantly financed from internal resources (grants, contributions, revenue and capital receipts) and that any increase in the underlying need to borrow is supported through the Revenue Support Grant system. However, any borrowing undertaken in 2015/15 and 2016/17 that is not supported either through internal funds or central grant will have an incremental impact on Council Tax.

Adoption of the CIPFA Treasury Management Code:

This indicator demonstrates that the Council 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 Full Council meeting on 27th February 2012.

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

This Council is aware that there is now a new indicator on net debt which has been considered; however, this is not detailed further as the Council currently has no plans to go into debt during the 2015-16 financial year.

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

These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates.

The upper limit for variable rate exposure has been set to ensure that the Council 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 31/03/15 £m or %	**2015-16 Approved £m or %**	**2015-16 Revised £m or %**	**2016-17 Estimate £m or %**	**2017-18 Estimate £m or %**	**2018-19 Estimate £m or %**
Upper Limit for Fixed Interest Rate Exposure	-£0.030	-£0.030	-£0.030	-£0.030	-£0.030	-£0.030
Upper Limit for Variable Interest Rate Exposure	-£0.012	-£0.012	-£0.012	-£0.012	-£0.012	-£0.012

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

As the Council's investments are substantially in excess of its borrowing, these calculations have resulted in a negative figure.

Maturity Structure of Fixed Rate borrowing:

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.

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.

Maturity structure of fixed rate borrowing	**Existing level (or Benchmark level) at 31/03/15 %**	**Lower Limit for 2015/16 %**	**Upper Limit for 2016/17 %**
Less than twelve months	0%	0%	100%
12 months – 10 years	0%	0%	100%
10 years plus	0%	0%	100%

Credit Risk:
The Council considers security, liquidity and yield, in that order, when making investment decisions with Security the most important. With the uncertainty in market, the Council is seeking to place investments for a short term and is effectively forgoing return in order to protect capital.

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

The Council 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
- 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.

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

Upper Limit for total principal sums invested over 364 days:
The purpose of this limit is to contain exposure to the possibility of loss that may arise as a result of the Council having to seek early repayment of the sums invested.

	2015-16 Approved £m	**2015-16 Revised £m**	**2016-17 Estimate £m**	**2017-18 Estimate £m**	**2018-19 Estimate £m**
Upper Limit for total principal sums invested over 364 days	15.0	15.0	15.0	15.0	15.0