TEES VALLEY COMBINED AUTHORITY

AGENDA ITEM 8

REPORT TO THE TEES VALLEY COMBINED AUTHORITY CABINET

29TH SEPTEMBER 2017

REPORT OF THE FINANCE DIRECTOR

TREASURY MANAGEMENT STRATEGY ANNUAL REPORT 2016/17

SUMMARY

This report informs Members of the performance against the treasury management and prudential indicators set in the Treasury Management Strategy approved by the TVCA Cabinet in April 2017.

RECOMMENDATIONS

It is recommended that the Tees Valley Combined Authority Cabinet approve the content of the report.

DETAIL

Introduction

1. In April 2017 the Authority adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* (the CIPFA Code) which requires the Authority to approve a treasury management annual report after the end of each financial year. This report fulfils the Authority's legal obligation to have regard to the CIPFA Code.

2. The Authority's treasury management strategy for 2016/17 was approved at a meeting of the Authority on 4th April 2017. The Authority has 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 are therefore central to the Authority's treasury management strategy.

External Context

3. **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.

4. 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% in April 2016 to 2.3% in March 2017.

5. 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.

6. 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.

7. 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%.

8. **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. The yield on the 10-year gilt rose from 0.75% at the end of September to 1.24% at the end of December, almost back at pre-referendum levels of 1.37% on 23rd June. 20- and 50-year gilt yields also rose in Q3 2017 to 1.76% and 1.70% respectively, however in Q4 yields remained flat at around 1.62% and 1.58% respectively.

9. 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.

10. Money market rates for overnight and one week periods remained low since Bank Rate was cut in August. 1- and 3-month LIBID rates averaged 0.36% and 0.47% respectively during 2016-17. Rates for 6- and 12-months increased between August and November, only to gradually fall back to August levels in March, they averaged 0.6% and 0.79% respectively during 2016-17.

11. **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.

12. 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.

13. 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.

Local Context

14. On 31st March 2017, the Authority had net investments of £78.058m 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

	31.3.17 Actual £m
General Fund CFR	0
Total CFR	**0**
Less: Other debt liabilities	0
Borrowing CFR	**0**
Usable reserves	87.316
Working Capital	-9.258
Net Investment	**78.058**

15. The Net Investment figure represents the authority's cash and cash equivalent and short term investment funds held at the 31st March 2017 inclusive of accrued interest. The treasury management position as at 31st March 2017 is show in table 2 below.

Table 2: Treasury Management Summary

	31.3.17 Balance £m
Long-term borrowing Short-term borrowing	0 0
Total borrowing	**0**
Long-term investments	0

Short-term investments Cash and cash equivalents	77,000 1,058
Total investments	**78,058**
Net Investments	**78,058**

Borrowing Activity

16. The Authority at the 31st March 2017 had limited powers to borrow and therefore did not enter into any borrowing agreements. All expenditure of a capital nature was funded through grants and contributions.

Investment Activity

17. The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2016/17, the Authority's investment balance ranged between £35m and £77m million due to timing differences between income and expenditure. These investments **generated £180k in interest during 2016/17**. The year-end investment position is show in table 3 below.

Table 3: Investment Position

Counterparty	Amount £	Rate %	Start Date	Maturity Date
Goldman's	5,000,000	0.50%	06-Mar-17	05-Jun-17
Lloyds	5,000,000	0.65%	06-Oct-16	06-Apr-17
Standard Life	5,000,000	0.29%	06-Oct-16	Money Market Fund
Federated	5,000,000	0.29%	06-Oct-16	Money Market Fund
Legal & General	5,000,000	0.28%	06-Oct-16	Money Market Fund
Blackrock	5,000,000	0.23%	06-Oct-16	Money Market Fund
Insight	5,000,000	0.28%	06-Oct-16	Money Market Fund
Barclays	10,000,000	0.45%	12-Oct-16	12-Apr-17
Santander	10,000,000	0.40%	12-Oct-16	95 Day Notice
Lloyds	5,000,000	0.60%	05-Dec-16	05-Jun-17
Nat West Bank	2,000,000	0.01%	12-Apr-16	Call Account
Hull	5,000,000	0.38%	07-Mar-17	07-Jun-17
Slough	5,000,000	0.43%	06-Mar-17	06-Sep-17
Telford	5,000,000	0.45%	07-Mar-17	07-Sep-17
	77,000,000	**0.37%**		

18. 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 investments before seeking the highest 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.

19. In furtherance of these objectives, and given the increasing risk and falling returns from short-term unsecured bank investments, the Authority diversified into money market funds which allowed the Authority the flexibility to have access to funds immediately. Also due to the high level of investments this diversification was required so that limits with counterparties set within the treasury management strategy were not breached during the year. Due to the developing capital expenditure plans of the Authority it was not prudent to diversify further into higher yielding asset classes during 2016/17. The progression of risk and return metrics are shown in the extracts from Arlingclose quarterly investment benchmarking in table 4 below.

Table 4: Investment Benchmarking

	Credit Score	Credit Rating	Bail-in Exposure	WAM* (days)	Rate of Return
31.12.2016	5.47	A+	100%	36	0.34%
31.03.2017	4.76	A+	81%	43	0.39%
Similar LAs	4.6	A+	74%	66	0.67
All LAs	4.3	AA-	60.%	47	1.14%

*Weighted average maturity

20. The Authority's best performing investments in 2016/17 were those with banks and other financial institutions where there were longer maturity dates. £35m was held in these funds across five counterparties at the 31st March 2017.

Compliance Report

21. The Director of Finance is pleased to report that all treasury management activities undertaken during 2016/17 complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 5 below.

Table 5: Investment Limits

	2016/17 Maximum	31.3.17 Actual*	2016/17 Limit	Complied
UK Banks, Foreign Banks and other organisations	£35m	£35m	£20m each	✓
Council's Own Clearing bank	£19m	£2m	£20m	✓
UK Building Societies without credit ratings	£0m	£0m	£7m each	✓
UK Local Authorities	£15m	£15m	£10m each	✓
UK Government DMO, Treasury Bills, Treasury Gilts & Instruments	£12m	£0m	Unlimited	✓
Money Market Funds	£25m	£25m	£5m each	✓

see table 3 above for values with individual counterparties as at 31st March 2017.

22. Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 6 below.

Table 6: Debt Limits

	2016/17 Maximum	31.3.17 Actual	2016/17 Operational Boundary	2016/17 Authorised Limit	Complied
Borrowing	£0	£0	£2m	£5m	✓

23. The operational boundary is based on the Authority's estimate of most likely (i.e. prudent but not worst case) scenario for external debt. It links directly to the Authority's estimates of capital expenditure, the capital financing requirement and cash flow requirements, and is a key management tool for in-year monitoring.

24. The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Authority can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

25. As the Authority has limited borrowing powers which it did not exercise during the year these limits were not breached.

Treasury Management Indicators

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

27. **Interest Rate Exposures**: 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 net principal invested was:

	31.3.17 Actual	2016/17 Limit	Complied
Upper limit on fixed interest rate exposure	65%	100%	✓
Upper limit on variable interest rate exposure	35%	100%	✓

28. Fixed rate investments and borrowings are those where the rate of interest was fixed at the point of investment. All other instruments are classed as variable rate.

29. **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 fixed rate borrowing were:

30.

	31.3.17 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	£0	0%	25%	✓
12 months and within 24 months	£0	0%	40%	✓
24 months and within 5 years	£0	0%	60%	✓
5 years and within 10 years	£0	0%	80%	✓

10 years and above	£0	0%	100%	✓

31. Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

32. **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:

	2016/17	**2017/18**	**2018/19**
Actual principal invested beyond year end	£0	£0	£0
Limit on principal invested beyond year end	£30m	£30m	£30m
Complied	✓	✓	✓

<u>Prudential Indicators</u>

33. The Local Government Act 2003 requires the Authority to have regard to the Chartered Institute of Public Finance and Accountancy's *Prudential Code for Capital Finance in Local Authorities* (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Authority has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

34. This report compares the approved indicators with the outturn position for 2016/17. Actual figures have been taken from or prepared on a basis consistent with, the Authority's statement of accounts.

35. **Capital Expenditure:** The Authority's capital expenditure and financing may be summarised as follows.

Capital Expenditure and Financing	**2016/17 Actual £m**
General Fund	28.339
Total Expenditure	**28.339**
Government Grants	(28.339)
Total Financing	**(28.339)**

36. **Capital Financing Requirement:** The Capital Financing Requirement (CFR) measures the Authority's underlying need to borrow for a capital purpose.

Capital Financing Requirement	**31.03.17 Estimate £m**	**31.03.17 Actual £m**	**Difference £m**
General Fund	0	0	0
Total CFR	**0**	**0**	**0**

37. **Gross Debt and the Capital Financing Requirement:** In order to ensure that over the medium term debt will only be for a capital purpose, the 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. This is a key indicator of prudence.

Debt and CFR	**31.03.17 Estimate £m**	**31.03.17 Actual £m**	**Difference £m**
Total debt	0	0	0
Capital financing requirement	0	0	0
Headroom	**0**	**0**	**0**

38. The Authority's capital expenditure during 2016/17 was fully funded through government grants and as such there was no requirement for it to enter into debt.

39. **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, net of investment income.

Ratio of Financing Costs to Net Revenue Stream	**31.03.17 Estimate %**	**31.03.17 Actual %**	**Difference %**
General Fund	0%	**0%**	0%

FINANCIAL IMPLICATIONS

40. Treasury Management Investment activity during 2016/17 generated income of £180k.

LEGAL IMPLICATIONS

41. None.

RISK ASSESSMENT

42. This Treasury Management Strategy annual report is categorised as low to medium risk. Existing management systems and daily routine activities are sufficient to control and reduce risk.

CONSULTATION

43. Not applicable.

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