AGENDA ITEM 15

REPORT TO THE TEES VALLEY COMBINED AUTHORITY CABINET

30 NOVEMBER 2018

REPORT OF THE HEAD OF FINANCE AND RESOURCES

TREASURY MANAGEMENT STRATEGY – ANNUAL REPORT 2017/18

SUMMARY

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

RECOMMENDATION

i. It is recommended that the Combined Authority Cabinet note the content of the report.

DETAIL

Introduction

1. The Authority operates under 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 a treasury management annual report after the end of each financial year.

2. This report fulfils the Authority's legal obligation to have regard to the CIPFA Code.

3. The Authority's Treasury Management Strategy for 2017/18 was approved at Cabinet on 31st January 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

Economic commentary

4. 2017-18 was characterised by the push-pull from expectations of tapering of Quantitative Easing (QE) and the potential for increased policy rates in the US and Europe and from geopolitical tensions, which also had an impact.

5. The UK economy showed signs of slowing with latest estimates showing GDP, helped by an improving global economy, grew by 1.8% in calendar 2017, the same level as in 2016. This was a far better outcome than the majority of forecasts following the EU Referendum in June 2016, but it also reflected the international growth momentum generated by the increasingly buoyant US economy and the re-emergence of the Eurozone economies.

6. The inflationary impact of rising import prices, a consequence of the fall in sterling associated with the EU referendum result, resulted in year-on-year CPI rising to 3.1% in November before falling back to 2.7% in February 2018. Consumers felt the squeeze as real average earnings growth, i.e. after inflation, turned negative before slowly recovering. The labour market showed resilience as the unemployment rate fell back to 4.3% in January 2018. The inherent weakness in UK business investment was not helped by political uncertainty following the surprise General Election in June and by the lack of clarity on Brexit, the UK and the EU only reaching an agreement in March 2018 on a transition which will now be span Q2 2019 to Q4 2020. The Withdrawal Treaty is yet to be ratified by the UK parliament and those of the other 27 EU member states and new international trading arrangements are yet to be negotiated and agreed.

7. The Bank of England's Monetary Policy Committee (MPC) increased Bank Rate by 0.25% in November 2017. It was significant in that it was the first rate hike in ten years, although in essence the MPC reversed its August 2016 cut following the referendum result. The February *Inflation Report* indicated the MPC was keen to return inflation to the 2% target over a more conventional (18-24 month) horizon with 'gradual' and 'limited' policy tightening. Although in March two MPC members voted to increase policy rates immediately and the MPC itself stopped short of committing itself to the timing of the next increase in rates, the minutes of the meeting suggested that an increase in May 2018 was highly likely.

8. **Financial markets:** The increase in Bank Rate resulted in higher money markets rates: 1-month, 3-month and 12-month LIBID rates averaged 0.32%, 0.39% and 0.69% and at 31st March 2018 were 0.43%, 0.72% and 1.12% respectively.

9. The FTSE 100 had a strong finish to calendar 2017, reaching yet another record high of 7688, before plummeting below 7000 at the beginning of 2018 in the global equity correction and sell-off.

Credit background:

Credit Metrics

10. The rules for UK banks' ring-fencing were finalised by the Prudential Regulation Authority and banks began the complex implementation process ahead of the statutory deadline of 1st January 2019. As there was some uncertainty surrounding which banking entities the Authority would be dealing with once ring-fencing was implemented and what the balance sheets of the ring-fenced and non ring-fenced entities would actually look like, in May 2017 Arlingclose advised adjusting downwards the maturity limit for unsecured investments to a maximum of

6 months. The rating agencies had slightly varying views on the creditworthiness of the restructured entities.

11. **Money Market Fund regulation:** The new EU regulations for Money Market Funds (MMFs) were finally approved and published in July and existing funds will have to be compliant by no later than 21st January 2019. The key features include Low Volatility Net Asset Value (LVNAV) Money Market Funds which will be permitted to maintain a constant dealing NAV, providing they meet strict new criteria and minimum liquidity requirements. MMFs will not be prohibited from having an external fund rating (as had been suggested in draft regulations). Arlingclose expects most of the short-term MMFs it recommends to convert to the LVNAV structure and awaits confirmation from each fund.

Other developments:

12. In February, Arlingclose advised against lending to Northamptonshire County Authority (NCC). NCC issued a section 114 notice in the light of severe financial challenge and the risk that it would not be in a position to deliver a balanced budget.

13. In March, following Arlingclose's advice, the Authority removed RBS plc and National Westminster Bank from its counterparty list. This did not reflect any change to the creditworthiness of either bank, but a tightening in Arlingclose's recommended minimum credit rating criteria to A- from BBB+ for FY 2018-19. The current long-term ratings of RBS and NatWest do not meet this minimum criterion, although if following ring-fencing NatWest is upgraded, the bank would be reinstated on the Authority's lending list.

Local Authority Regulatory Changes

14. **Revised CIPFA Codes:** CIPFA published revised editions of the Treasury Management and Prudential Codes in December 2017. The required changes from the 2011 Code are being incorporated into Treasury Management Strategies and monitoring reports.

15. The 2017 Prudential Code introduces the requirement for a Capital Strategy which provides a high-level overview of the long-term context of capital expenditure and investment decisions and their associated risks and rewards along with an overview of how risk is managed for future financial sustainability. Where this strategy is produced and approved by full Authority, the determination of the Treasury Management Strategy can be delegated to a committee. The Code also expands on the process and governance issues of capital expenditure and investment decisions.

16. The Authority will be preparing the Capital Strategy for the 2019/20 financial year.

17. In the 2017 Treasury Management Code the definition of 'investments' has been widened to include financial assets as well as non-financial assets held primarily for financial returns such as investment property. These, along with other investments made for non-treasury management purposes such as loans supporting service outcomes and investments in subsidiaries, must be discussed in the Capital Strategy or Investment Strategy. Additional risks of such investments are to be set out clearly and the impact on financial sustainability identified and reported.

18. **MHCLG Investment Guidance and Minimum Revenue Provision (MRP):** In February 2018 the MHCLG (Ministry of Housing, Communities and Local Government) published revised Guidance on Local Government and Investments and Statutory Guidance on Minimum Revenue Provision (MRP).

19. Changes to the Investment Guidance include a wider definition of investments to include non-financial assets held primarily for generating income return and a new category called “loans” (e.g. temporary transfer of cash to a third party, joint venture, subsidiary or associate). The Guidance introduces the concept of proportionality, proposes additional disclosure for borrowing solely to invest and also specifies additional indicators. Investment strategies must detail the extent to which service delivery objectives are reliant on investment income and a contingency plan should yields on investments fall.

20. The definition of prudent MRP has been changed to “put aside revenue over time to cover the Capital Financing Requirement (CFR)”; it cannot be a negative charge and can only be zero if the CFR is nil or negative. Guidance on asset lives has been updated, applying to any calculation using asset lives. Any change in MRP policy cannot create an overpayment; the new policy must be applied to the outstanding CFR going forward only.

21. **MiFID II:** As a result of the second Markets in Financial Instruments Directive (MiFID II), from 3rd January 2018 local authorities were automatically treated as retail clients but could “opt up” to professional client status, providing certain criteria was met which includes having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the authority have at least a year’s relevant professional experience. In addition, the regulated financial services firms to whom this directive applies have had to assess that that person(s) have the expertise, experience and knowledge to make investment decisions and understand the risks involved.

22. The Authority has met the conditions to opt up to professional status and has done so in order to maintain its erstwhile MiFID II status prior to January 2018. The Authority will continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

Local Context

23. On 31st March 2018, the Authority had net investments of £91.0m arising from its revenue and capital income and expenditure, an increase on 2017 of £12.98m. 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 and the year-on-year change are summarised in table 1 below.

Table 1: Balance Sheet Summary

	31.3.17 Actual £m	2017/18 Movement £m	31.3.18 Actual £m
General Fund CFR	0.00	0.00	0.00
Less: Other debt liabilities	0.00	0.00	0.00
Borrowing CFR	**0.00**	**0.00**	**0.00**
Less: Usable reserves	-87.32	-7.61	-94.93
Less: Working capital	9.30	-5.37	3.93
Net investments	**-78.02**	**-12.98**	**-91.00**

24. The Authority's strategy was to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low. The treasury management position as at 31st March 2018 and the year-on-year change in show in table 2 below.

Table 2: Treasury Management Summary

	31.3.17 Balance £m	2017/18 Movement £m	31.3.18 Balance £m	31.3.18 Rate %
Long-term borrowing Short-term borrowing	0.00 0.00	0.00 0.00	0.00 0.00	
Total borrowing	**0.00**	**0.00**	**0.00**	**0.00%**
Long-term investments Short-term investments Cash and cash equivalents	0.00 50.01 28.01	0.00 14.99 -2.01	0.00 65.00 26.00	
Total investments	**78.02**	**12.98**	**91.00**	**0.46%**
Net investments	**-78.02**	**-12.98**	**-91.00**	

Note: the figures in the table are from the balance sheet in the Authority's statement of accounts, but adjusted to exclude operational cash, accrued interest and other accounting adjustments.

25. The increase in total investments in table 2 represents funding received in advance of expenditure.

Borrowing Activity

26. The Authority at the 31st March 2018 had received the relevant powers required to borrow but did not enter into any borrowing agreements. All expenditure of a capital nature was funded through grants and contributions.

Investment Activity

27. The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2017/18, the Authority's investment balance ranged between £131.0m and £91.0m million due to timing differences between income and expenditure. The year-end investment position is show in table 3 below.

Table 3: Investment Position (Treasury Investments)

Counterparty	Amount £	Rate %	Start Date	Maturity Date
Nat West SIBA	3,000,000	0.15%	n/a	Call Account
Bank of Scotland	5,000,000	0.50%	06-Mar-18	06-Jun-18
Bank of Scotland	5,000,000	0.36%	06-Oct-17	06-Apr-18
Coventry Building Society	5,000,000	0.44%	11-Oct-17	11-Apr-18
Goldman Sachs	5,000,000	0.43%	29-Dec-17	06-Apr-18
Santander 95 days notice	10,000,000	0.60%	17-Aug-15	95 day Notice
Birmingham City	5,000,000	0.47%	22-Jan-18	23-Apr-18
Leeds City	5,000,000	0.40%	19-Oct-17	19-Apr-18
Merthr Tydfil	5,000,000	0.50%	22-Dec-17	23-Apr-18
Northamptonshire	5,000,000	0.55%	05-Oct-17	05-Jul-18
Stirling	3,000,000	0.50%	23-Nov-17	23-May-18
Suffolk County	5,000,000	0.75%	09-Mar-18	08-Jun-18
Surrey Heath Council	2,000,000	0.50%	22-Nov-17	22-May-18
Telford & Wrekin	5,000,000	0.75%	15-Mar-18	15-Jun-18
Standard Life	10,000,000	0.29%	06-Oct-16	Money Market Fund
Federated	10,000,000	0.29%	06-Oct-16	Money Market Fund
Insight	3,000,000	0.28%	17-Dec-16	Money Market Fund
	91,000,000	**0.46%**		

28. 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.

29. In furtherance of these objectives, and due to the high level of investments diversification was required so that limits with counterparties set within the treasury management strategy were not breached during the year. Funds were diversified between Money Market Funds, Banks and Local Authorities. Due to the developing capital expenditure plans of the Authority it was not prudent to diversify further into higher yielding asset classes during 2017/18. 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
31.03.2017	4.76	A+	81%	43	0.39%
30.06.2017	4.34	AA-	68%	39	0.32%
30.09.2017	4.53	AA-	68%	40	0.30%
31.12.2017	4.49	AA-	56%	69	0.40%
31.03.2018	4.35	AA-	62%	35	0.48%
Similar LAs	4.14	AA-	48%	39	1.07%
All LAs	4.24	AA-	55%	35	1.05%

**Weighted average maturity*

30. Due to the interest rate rise during 2017/18 the Authority has been able to secure higher rates as the year progressed and initial investments matured. The intention during 2018/19 is to invest funds over longer periods which will mean the authority should achieve higher rates of return.

Financial Implications

31. The outturn for investment income received in 2017/18 was £0.395 million on an average portfolio of £109.03 million.

Other Non-Treasury Holdings and Activity

32. Although not classed as treasury management activities, the 2017 CIPFA Code now requires the Authority to report on investments for policy reasons outside of normal treasury management. This includes service investments for operational and/or regeneration as well as commercial investments which are made mainly for financial reasons. The Authority did not hold any of these types of investments during 2017/18.

Compliance Report

33. The Director of Finance is pleased to report that the majority of treasury management activities undertaken during 2017/18 complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy with the exception of one of the investment limits shown in table 6.

34. Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 5 below.

Table 5: Debt Limits

	2017/18 Maximum	31.3.18 Actual	2017/18 Operational Boundary £m	2017/18 Authorised Limit £m	Complied
Borrowing	0.0	0.0	0.0	10.0	✓
PFI & finance leases	0.0	0.0	0.0	0.0	✓
Total debt	**0.0**	**0.0**	**0.0**	**10.0**	✓

35. 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. Total debt was above the operational boundary for 0 days during 2017/18.

36. Compliance with specific investment limits is demonstrated in table 6 below.

Table 6: Investment Limits

Type of Institution	**2017/18 Maximum**	**31.3.18 Actual**	**Financial Limit**	**Time Limit**	**Complied**
UK central government (irrespective of credit rating)	£3m	£0m	Unlimited	Unlimited	✓
UK local authorities, Police & Crime Commissioners, Fire Authorities	£40m	£35m	£10m each	1 – 3 years	✓
UK banks with AAA, AA+, AA, AA-, A+ and A credit ratings	£35m	£25m	£15m each	1 year unsecured / 2 years secured	✓
UK banks with A- credit rating	£0m	£0m	£10m each	6 month unsecured / 1 year secured	✓
UK banks with BBB+ credit rating	£18m	£3m	£2.5m each	100 days unsecured / 6 months secured	*X*[1]
UK money market funds	£50m	£23m	£10m each	Unlimited	✓
UK building societies with AAA, AA+, AA, AA-, A+ and A credit ratings	£5m	£5m	£10m each	1 year unsecured / 2 years secured	✓
UK building societies with A- credit rating	£0m	£0m	£5m each	6 month unsecured / 1 year secured	✓
UK building societies with BBB+ credit rating	£0m	£0m	£1m each	100 days unsecured / 6 months secured	✓
UK building societies without a credit rating with assets greater than £250m	£0m	£0m	£5m each	6 month unsecured / 1 year secured	✓

Banks with AAA, AA+, AA, AA-, A+ and A credit ratings domiciled in AAA rated sovereign countries	£0m	£0m	£5m each	1 year unsecured / 2 years secured	✓

**see Table 4 above for values with individual counterparties as at 31st March 2018*.

37. [1]This breach relates to the Authority's own bank Nat West which is used for day to day banking transactions and concerned funds placed in the Authority's transactional account in order to cover payments being made using BACS over the Christmas period. The Audit and Governance Committee considered this issue at its meeting on 27 September 2018 where it was resolved that a mechanism be developed in order to report technical compliance breaches such as this, which are "pre-approved and well-considered".

Treasury Management Indicators

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

39. **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 principle invested was:

	31.3.18 Actual	**31.3.18 Actual**	**2017/18 Limit**	**Complied**
Upper limit on fixed interest rate exposure	£68m	75%	100%	✓
Upper limit on variable interest rate exposure	£23m	25%	100%	✓

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

41. **Principal Sums Invested over 365 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:

	2017/18	**2018/19**	**2019/20**
Actual principal invested beyond year end	£0m	£0m	£0m
Limit on principal invested beyond year end	£60m	£60m	£60m
Complied	✓	✓	✓

PRUDENTIAL INDICATORS 2017/18

42. **Introduction:** 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 is 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.

43. This report compares the approved indicators with the outturn position for 2017/18. Actual figures have been taken from or prepared on a basis consistent with, the Authority's statement of accounts.

44. **Capital Expenditure:** The Authority's capital expenditure and financing is summarised as follows.

Capital Expenditure and Financing	**2017/18 Estimate £m**	**2017/18 Actual £m**	**Difference £m**
Total Expenditure	**64.2**	**43.15**	**-21.05**
Capital Receipts	0	0.00	**0**
Grants & Contributions	64.2	40.33	**-23.87**
Revenue	0	2.82	**2.82**
Borrowing	0	0.00	**0**
Total Financing	**64.2**	**43.15**	**-21.05**

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

Capital Financing Requirement	**31.03.18 Estimate £m**	**31.03.18 Actual £m**	**Difference £m**
General Fund	0.0	0.0	**0.0**
Total CFR	**0.0**	**0.0**	**0.0**

46. **Actual Debt:** The Authority's actual debt at 31st March 2018 was as follows:

Debt	**31.03.18 Estimate £m**	**31.03.18 Actual £m**	**Difference £m**
Borrowing	0.0	0.0	**0.0**
Finance leases	0.0	0.0	**0.0**
Total Debt	**0.0**	**0.0**	**0.0**

47. **Operational Boundary for External Debt:** 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. Other long-term liabilities comprise finance lease, Private Finance Initiative and other liabilities that are not borrowing but form part of the Authority's debt.

Operational Boundary and Total Debt	31.03.18 Boundary £m	31.03.18 Actual Debt £m	Complied
Borrowing	0.0	0.0	✓
Other long-term liabilities	0.0	0.0	✓
Total Debt	**0.0**	**0.0**	✓

48. **Authorised Limit for External Debt:** 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.

Authorised Limit and Total Debt	31.03.18 Limit £m	31.03.18 Actual Debt £m	Complied
Borrowing	10.0	0.0	✓
Other long-term liabilities	0.0	0.0	✓
Total Debt	**10.0**	**0.0**	✓

49. **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	31.03.18 Estimate %	31.03.18 Actual %	Difference %
General Fund	0%	0%	0%

FINANCIAL IMPLICATIONS

50. Treasury Management Investment activity during 2016/17 generated income of £395k.

LEGAL IMPLICATIONS

51. None.

RISK ASSESSMENT

52. 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

53. Not applicable.

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