

AGENDA ITEM 10**REPORT TO THE TEES VALLEY
COMBINED AUTHORITY CABINET****31 JANUARY 2019****REPORT OF THE HEAD OF
FINANCE AND RESOURCES****TREASURY MANAGEMENT STRATEGY MID TERM REVIEW 2018/19****SUMMARY**

This report informs Cabinet of the mid-year performance against the treasury management and prudential indicators set in the Treasury Management Strategy approved by the Combined Authority in March 2018. The Combined Authority Audit and Governance Committee considered the report at their meeting on 29th November.

RECOMMENDATION

It is recommended that the Combined Authority Cabinet note the report.

DETAIL

1. The Combined 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.
2. Combined Authority's Treasury Management strategy for 2018/19 has received approval at the 28th March 2018 meeting. The Combined 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 is therefore central to the Treasury Management strategy.
3. Following consultation in 2017, CIPFA published new versions of the Prudential Code for Capital Finance in Local Authorities (Prudential Code) and the Treasury Management Code of Practice but has yet to publish the local authority specific Guidance Notes to the latter. In England the Ministry for Housing Communities and Local Government (MHCLG) published its revised Investment Guidance which came into effect from April 2018.
4. The updated Prudential Code includes a new requirement for local authorities to provide a Capital Strategy for 2019/20, which is to be a summary document

approved by Cabinet, covering capital expenditure, financing, Treasury Management and non-treasury investments. The Authority will be producing its Capital Strategy later in 2018-19 for approval by Cabinet.

EXTERNAL CONTEXT

5. Economic background: Oil prices rose by 23% over the six months to around \$82/barrel. UK Consumer Price Inflation (CPI) for August rose to 2.7% year/year, above the consensus forecast and that of the Bank of England's in its August Inflation Report, as the effects of sterling's large depreciation in 2016 began to fade. The most recent labour market data for July 2018 showed the unemployment rate at 4%, its lowest since 1975. The 3-month average annual growth rate for regular pay, i.e. excluding bonuses, was 2.9% providing some evidence that a shortage of workers is providing support to wages. However real wages (i.e. adjusted for inflation) grew only by 0.2%, a marginal increase unlikely to have had much effect on households.
6. The Bank of England made no change to monetary policy at its meetings in May and June, however hawkish minutes and a 6-3 vote to maintain rates was followed by a unanimous decision for a rate rise of 0.25% in August, taking Bank Rate to 0.75%.
7. The EU Withdrawal Bill, which repeals the European Communities Act 1972 that took the UK into the EU and enables EU law to be transferred into UK law, narrowly made it through Parliament. With just six months to go when Article 50 expires on 29th March 2019, neither the Withdrawal Agreement between the UK and the EU which will be legally binding on separation issues and the financial settlement, nor its annex which will outline the shape of their future relationship, have been finalised, extending the period of economic uncertainty.
8. The ringfencing of the big four UK banks - Barclays, Bank of Scotland/Lloyds, HSBC and RBS/Natwest Bank plc – is complete, the transfer of their business lines into retail (ringfenced) and investment banking (non-ringfenced) is progressing and will need to be completed by the end of 2018.
9. There were a few credit rating changes during the period. Moody's downgraded Barclays Bank plc's long-term rating to A2 from A1 and NatWest Markets plc to Baa2 from A3 on its view of the credit metrics of the entities post ringfencing. Upgrades to long-term ratings included those for Royal Bank of Scotland plc, NatWest Bank and Ulster Bank to A2 from A3 by Moody's and to A- from BBB+ by both Fitch and Standard & Poor's (S&P). Lloyds Bank plc and Bank of Scotland plc were upgraded to A+ from A by S&P and to Aa3 from A1 by Moody's.

LOCAL CONTEXT

10. On 31st March 2018, the Combined Authority had net investments of £91.0m 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

| | 31.3.18 Actual £m |
|------------------------------|----------------------------------|
| General Fund CFR | 0 |
| Less: Other debt liabilities | 0 |
| Borrowing CFR | 0 |
| Less: Usable reserves | -94.93 |
| Less: Working capital | 3.93 |
| Net investments | -91.00 |

11. Combined Authority's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

12. The Treasury Management position at the 30th September 2018 and the change during the period is show in Table 2 below.

Table 2: Treasury Management Summary

| | 31.3.18 Balance £m | Movement £m | 30.9.18 Balance £m |
|---------------------------|-----------------------------------|------------------------|-----------------------------------|
| Long-term borrowing | 0.0 | 0.0 | 0.0 |
| Short-term borrowing | 0.0 | 0.0 | 0.0 |
| Total borrowing | 0.0 | 0.0 | 0.0 |
| Long-term investments | 0.0 | 0.0 | 0.0 |
| Short-term investments | -65.0 | -10.0 | -75.0 |
| Cash and cash equivalents | -26.0 | -2.0 | -28.0 |
| Total investments | -91.0 | -12.0 | -103.0 |
| Net investments | -91.0 | -12.0 | -103.0 |

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

BORROWING STRATEGY DURING THE PERIOD

14. On the 30th September 2018 the Combined Authority 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.

TREASURY INVESTMENT ACTIVITY

15. The Combined Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the six-month period, the average monthly investment balance ranged between £124m and £102m, due to timing differences between income and expenditure. The investment position on the 30th September is shown in table 3 below.

Table 3: Treasury Investment Position

| | 31.3.18 Balance £m | Net Movement £m | 30.9.18 Balance £m |
|---|-----------------------------------|--------------------------------|-----------------------------------|
| Banks & building societies (unsecured) | -33.0 | -7.0 | -40.0 |
| Government (incl. local authorities) | -35.0 | 0.0 | -35.0 |
| Money Market Funds | -23.0 | -5.0 | -28.0 |
| Total investments | -91.0 | -12.0 | -103.0 |

16. 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.
17. In furtherance of these objectives, and due to the high level of investments we have continued diversification so that limits with counterparties set within the treasury management strategy were not breached. 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 the first part of 2018/19. 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 – Treasury investments managed in-house

| | Credit Score | Credit Rating | Bail-in Exposure | WAM* (days) | Rate of Return % |
|--------------------|--------------|---------------|------------------|-------------|------------------|
| 31.03.2018 | 4.35 | AA- | 62% | 35 | 0.48% |
| 30.06.2018 | 4.53 | A+ | 70% | 66 | 0.62% |
| 30.09.2018 | 4.17 | AA- | 66% | 82 | 0.69% |
| Similar LAs | 4.23 | AA- | 58% | 60 | 1.21% |
| All LAs | 4.1 | AA- | 60% | 37 | 1.25% |

*Weighted average maturity

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

NON-TREASURY INVESTMENTS

19. 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. The Authority does not hold any such investments.

COMPLIANCE

20. The Head of Finance and Resources reports that all Treasury Management activities undertaken during the first part of the year, fully complied 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 5 below.

Table 5: Debt Limit

| | Maximum in Year | 30.9.18 Actual | 2018/19 Operational Boundary | 2018/19 Authorised Limit | Complied? Yes/No |
|------------------------|-----------------|----------------|------------------------------|--------------------------|------------------|
| Borrowing | £0 | £0 | £75m | £100m | Yes |
| PFI and Finance Leases | £0 | £0 | £0 | £0 | Yes |
| Total debt | £0 | £0 | £75m | £100m | |

21. 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 never exceeded the operational boundary during the six-month period. Compliance with specific investment limits is demonstrated in table 6 below

Table 6: Investment Limits

| | Maximum in Year | 30.9.18 Actual | 2018/19 Limit | Complied? Yes/No |
|---|------------------------|-----------------------|-----------------------|-------------------------|
| Any single organisation, except the UK Government | £27.5m | £27.5m | £15m per organisation | Yes |
| UK Government / LA's | £55m | £35m | Unlimited | Yes |
| Any group of organisations under the same ownership | £0m | £0m | £15m per organisation | Yes |
| Any group of pooled funds under the same management | £0m | £0m | £37.5m | Yes |
| Negotiable instruments held in a broker's nominee account | £0m | £0m | £37.5m | Yes |
| Limit per non-UK country | £0m | £0m | £15m | Yes |
| Registered providers | £0m | £0m | £37.5m | Yes |
| Unsecured investments with building societies | £12.5m | £12.5m | £15m | Yes |
| Loans to unrated corporates | £0m | £0m | £15m | Yes |
| Money Market Funds | £66m | £28m | £75m | Yes |

TREASURY MANAGEMENT INDICATORS

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

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 amount of net principal borrowed / interest payable was:

| | 30.9.18 Actual | 2018/19 Limit | Complied? |
|--|-----------------------|----------------------|------------------|
| Upper limit on fixed interest rate exposure | -£0.226m | £20m | Yes |
| Upper limit on variable interest rate exposure | -£0.116m | £20m | Yes |

23. Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments are classed as variable rate.

24. 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:

| | 30.9.18 Actual | Upper Limit | Lower Limit | Complied? |
|--------------------------------|-----------------------|--------------------|--------------------|------------------|
| Under 12 months | 0% | 25% | 0% | Yes |
| 12 months and within 24 months | 0% | 40% | 0% | Yes |
| 24 months and within 5 years | 0% | 60% | 0% | Yes |
| 5 years and within 10 years | 0% | 80% | 0% | Yes |
| 10 years and above | 0% | 100% | 0% | Yes |

25. Principal Sums Invested for Periods Longer than 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:

| | 2018/19 | 2019/20 | 2019/21 |
|---|----------------|----------------|----------------|
| Actual principal invested beyond year end | £0 | £0 | £0 |
| Limit on principal invested beyond year end | £60m | £40m | £20m |
| Complied? | Yes | Yes | Yes |

OUTLOOK FOR THE REMAINDER OF 2018/19

26. Having raised policy rates in August 2018 to 0.75%, the Bank of England's Monetary Policy Committee (MPC) has maintained expectations of a slow rise in interest rates over the forecast horizon.

27. The MPC has a definite bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. While policymakers are wary of domestic inflationary pressures over the next two years, it is believed that the MPC members consider both that (a) ultra-low interest rates result in other economic problems, and that (b) higher Bank Rate will be a more effective weapon should downside Brexit risks crystallise and cuts are required.

28. Arling close's central case is for Bank Rate to rise twice in 2019. The risks are weighted to the downside. The UK economic environment is relatively soft, despite seemingly

strong labour market data. GDP growth recovered somewhat in Q2 2018, but the annual growth rate of 1.2% remains well below the long term average

| | Sep-18 | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Jun-21 | Sep-21 |
|--------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Official Bank Rate | | | | | | | | | | | | | |
| Upside risk | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |
| Arlingclose Central Ca: | 0.75 | 0.75 | 1.00 | 1.00 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 |
| Downside risk | 0.00 | 0.00 | 0.50 | 0.50 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 |

29. The view is that the UK economy still faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. Central bank actions and geopolitical risks, such as prospective trade wars, have and will continue to produce significant volatility in financial markets, including bond markets.

FINANCIAL IMPLICATIONS

30. Treasury Management Investment activity during the 6 months to 30th September 2018 generated income of £341.5k.

LEGAL IMPLICATIONS

31. There are no legal implications in this report.

RISK ASSESSMENT

32. 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

33. The Combined Authority Audit and Governance Committee considered the report at their meeting on 29th November 2018.

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