ITEM: 10

REPORT TO: WEST OF ENGLAND COMBINED AUTHORITY

DATE: 30th OCTOBER 2017

REPORT TITLE: TREASURY MANAGEMENT MONITORING REPORT TO 30TH SEPTEMBER 2017

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Appendix 1 – Performance Against Prudential Indicators
Appendix 2 – The Authority's Investment Position at 30th September 2017
Appendix 3 – Average monthly rate of return for 1st 6 months of 2017/18
Appendix 4 – The Authority's External Borrowing Position at 30th September 2017
Appendix 5 – Arlingclose's Economic & Market Review Q2 of 2017/18
Appendix 6 – Interest & Capital Financing Budget Monitoring 2017/18
Appendix 7 – Summary Guide to Credit Ratings

1.0 PURPOSE OF REPORT

1.1 The CIPFA Treasury Management in the Public Services: Code of Practice requires the Authority to approve a Treasury Management Strategy before the start of each financial year, review performance during the year, and approve an annual report after the end of each financial year. This report provides a review of performance to 30th September 2017.

2.0 ISSUES FOR CONSIDERATION

SUMMARY

2.1 The average rate of investment return for the first six months of 2017/18 is 0.42%, which is 0.26% above the benchmark rate.

2.2 The Authority's Prudential Indicators for 2017/18 were agreed by the Authority at its meeting on 1st March 2017 and performance against the key indicators is shown in **Appendix 1**. All indicators are within target levels.

SUMMARY OF RETURNS

2.3 The Authority's investment position as at 30th September 2017 is given in **Appendix 2**.

2.4 The Authority is the Accountable Body for the West of England Revolving Investment Fund (RIF) a role previously undertaken by B&NES who received grant funding of £57 million at the end of the 2011/12 financial year. Balances of £30.8m were transferred and this sum, prior to distribution, is being invested in line with the Authority's overall Treasury Management Strategy, with the interest earmarked to the RIF.

2.5 The Authority also acts as Accountable Body for the West of England Local Enterprise Partnership (WoE LEP). In 2017/18 £49.8m of Local Growth Fund (LGF) grant was received from Central Government along with the remaining balance from 2016/17 of £1.8m. The sum, prior to distribution, is being invested in line with the Authority's overall Treasury Management Strategy and with interest earmarked to fund associated operating and governance costs.

2.6 Gross interest earned on all investments for the first six months totalled £256k. **Appendix 3** details the investment performance, showing the average rate of interest earned over this period was 0.42%, which was 0.26% above the benchmark rate of average 7 day LIBID +0.05% (0.16%). This arises from the slightly longer investment duration arising on the funds as investment periods range from an on-call basis out to 12 months.

SUMMARY OF BORROWINGS

2.7 The Authority's currently has no external borrowing. Any future borrowing requirement would be subject to the Authority's decision making process and HM Treasury negotiations. For reference only, the statutory framework for Borrowing is set out in **Appendix 1.**

STRATEGIC & TACTICAL DECISIONS

2.8 As shown in the charts at **Appendix 2**, the investment portfolio has been diversified across UK Banks and Building Societies and Local Authorities, which totalled £113m The Authority also uses AAA rated Money Market funds to maintain very short-term liquidity with £22m invested in Money Market Funds as at 30th September 2017.

2.9 The Authority has placed £5m in the CCLA Property Fund to enhance yields and provide further diversification. This is intended to be held for higher return over a long period of time.

2.10 The Authority does not hold any direct investments with banks in countries within the Eurozone reflecting both on the underlying debt issues in some Eurozone countries and the low levels of interest rates. The Authority's investment counterparty list does not currently include any banks from Portugal, Ireland, Greece, Spain and Italy.

2.11 The Authority's average investment return is 0.42% which is above budgeted levels.

FUTURE STRATEGIC & TACTICAL ISSUES

2.12 The Authority's treasury management advisors have provided an economic and market review for the first quarter 2017/18 – attached at **Appendix 5**.

2.13 The Bank of England base rate was reduced to 0.25% on 4th August 2016. In the latest opinion of the Authority's treasury advisors is to maintain its central case for Bank Rate at 0.25% on the overall economic outlook. However, this decision is still very data dependant and they noted that the Bank of England's Monetary Policy Committee has changed its rhetoric, implying a rise in Bank Rate in "the coming months".

3.0 FINANCIAL IMPLICATIONS

3.1 A breakdown of the revenue budget for interest and the forecast year end position based on the period April to September is included in **Appendix 6**. This position will be kept under review during the remainder of the year, taking into account the Authority's cash-flow position.

4.0 LEGAL IMPLICATIONS

4.1 The Prudential Code and CIPFA's Code of Practice on Treasury Management requires regular monitoring and reporting of Treasury Management activities.

5.0 HUMAN RESOURCES IMPLICATIONS

5.1 None directly arising from this report.

6.0 ENVIRONMENTAL IMPLICATIONS

6.1 None directly arising from this report.

7.0 EQUALITY IMPACT IMPLICATIONS

7.1 None directly arising from this report.

8.0 RISK MITIATIONS & OPPORTUNITIES

8.1 The Authority's lending & borrowing list is regularly reviewed during the financial year and credit ratings are monitored throughout the year. All lending/borrowing transactions are within approved limits and with approved institutions. Investment and Borrowing advice is provided by our Treasury Management consultants Arlingclose.

8.2 The CIPFA Treasury Management in the Public Services: Code of Practice requires the Authority nominate a committee to be responsible for ensuring effective scrutiny of the Treasury Management Strategy and policies. The WECA Audit Committee carries out this role.

9.0 RECOMMENDATIONS

The WECA Committee is recommended to:

9.1 Note the Treasury Management Report to 30th September 2017, prepared in accordance with the CIPFA Treasury Code of Practice

9.2 Note the Treasury Management Indicators to 30th September 2017

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Background Papers *: Treasury Management Strategy Statement & Investment Strategy 2017/18 – As reported to WECA Committee on 1st March 2017.*

APPENDIX 1

Performance against Treasury Management Indicators agreed in Treasury Management Strategy Statement

1. Authorised limit for external debt

These limits include current commitments and proposals in the budget report for capital expenditure, plus additional headroom over & above the operational limit for unusual cash movements.

	2017/18 Prudential Indicator	**Actual as at 30th September 2017**
	£'000	£'000
Borrowing	0	0
Other long term liabilities	0	0
Cumulative Total	**0**	**0**

2. Operational limit for external debt

The operational boundary for external debt is based on the same estimates as the authorised limit but without the additional headroom for unusual cash movements.

	2017/18 Prudential Indicator	**Actual as at 30th September 2017**
	£'000	£'000
Borrowing	0	0
Other long term liabilities	0	0
Cumulative Total	**0**	**0**

3. Upper limit for fixed interest rate exposure

This is the maximum amount of total borrowing which can be at fixed interest rate, less any investments for a period greater than 12 months which has a fixed interest rate.

	2017/18 Prudential Indicator	**Actual as at 30th September 2017**
	%	%
Fixed interest rate exposure	**100**	**0**

4. Upper limit for variable interest rate exposure

While fixed rate borrowing contributes significantly to reducing uncertainty surrounding interest rate changes, the pursuit of optimum performance levels may justify keeping flexibility through the use of variable interest rates. This is the maximum amount of total borrowing which can be at variable interest rates.

	2017/18 Prudential Indicator	**Actual as at 30th September 2017**
	%	%
Variable interest rate exposure	**10%**	**0%**

5. Upper limit for total principal sums invested for over 364 days

This is the maximum amount of total investments which can be over 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.

	2017/18 Prudential Indicator	**Actual as at 30th September 2017**
	%	%
Investments over 364 days	**30**	**0**

6. Maturity Structure of borrowing

This indicator is set to control the Authority's exposure to refinancing risk.

	Upper Limit	**Lower Limit**	**Actual as at 30th September 2017**
	%	%	%
Under 12 months	50	Nil	0
12 months and within 24 months	75	Nil	0
24 months and within 5 years	75	Nil	0
5 years and within 10 years	100	Nil	0
10 years and above	100	Nil	0

7. Average Credit Rating

The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the weighted average credit rating of its investment portfolio. A summary guide to credit ratings is set out at **Appendix 7**.

	2017/18 Prudential Indicator	**Actual as at 30th September 2017**
	Rating	Rating
Minimum Portfolio Average Credit Rating	**A-**	**AA+**

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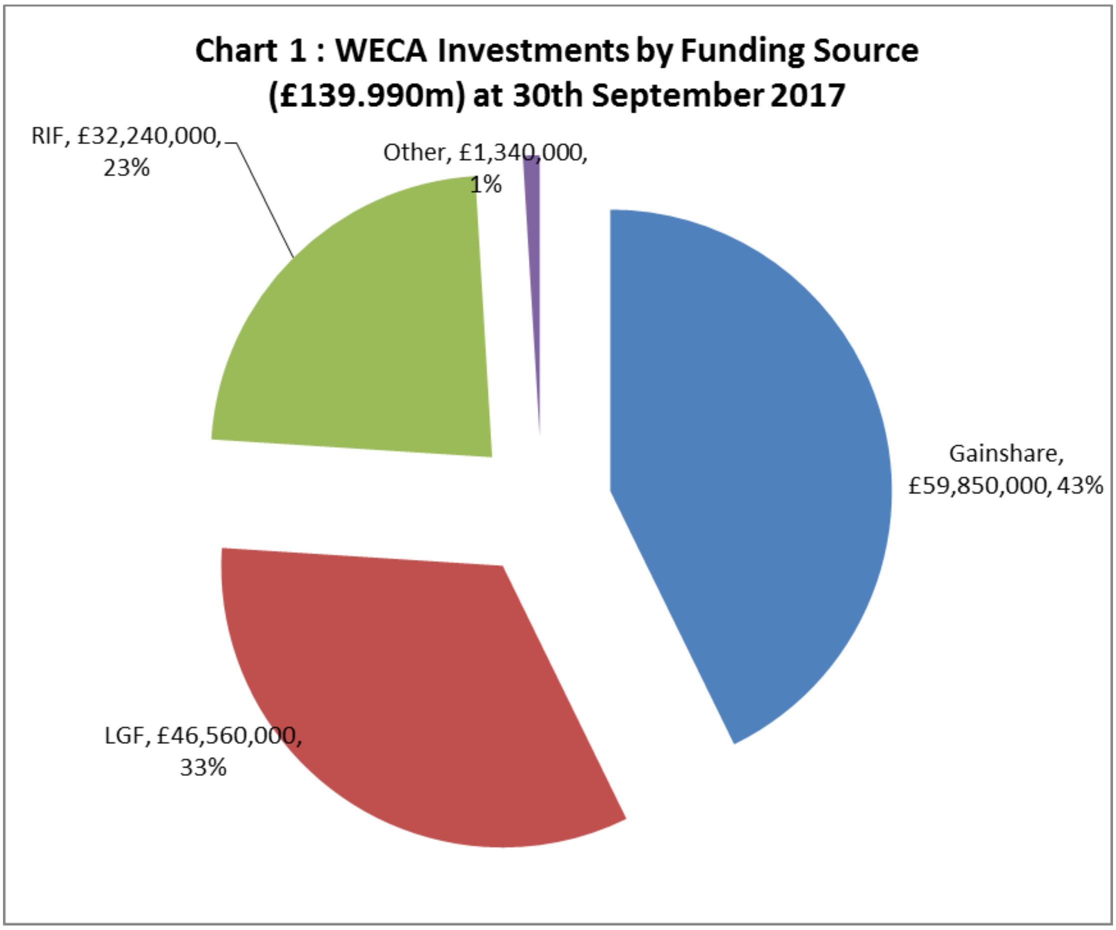
APPENDIX 2

The Authority's Investment position at 30th September 2017

The term of investments, from the original date of the deal, are as follows:

	Balance at 30th September 2017
	£'000's
Notice (instant access funds)	21,990
Up to 1 month	30,000
1 month to 3 months	28,000
4 to 6 months	30,000
6 to 12 months	25,000
Property Fund	5,000
Total	**139,900**

The Authority had a total average net positive balance of £121.8m during the period April 2017 to September 2017 .



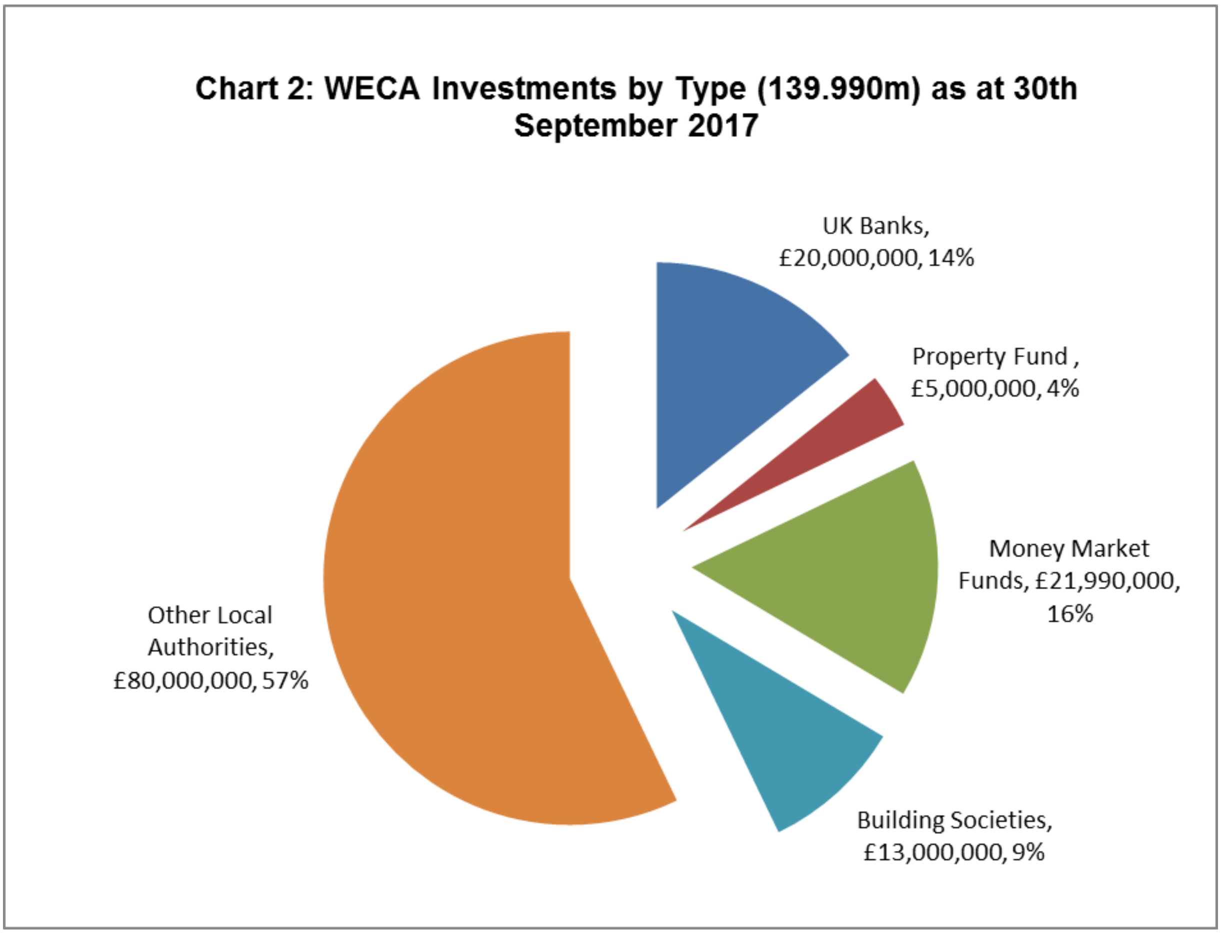


Chart 2: WECA Investments by Type (139.990m) as at 30th September 2017
UK Banks, £20,000,000, 14%
Property Fund , £5,000,000, 4%
Money Market Funds, £21,990,000, 16%
Building Societies, £13,000,000, 9%
Other Local Authorities, £80,000,000, 57%

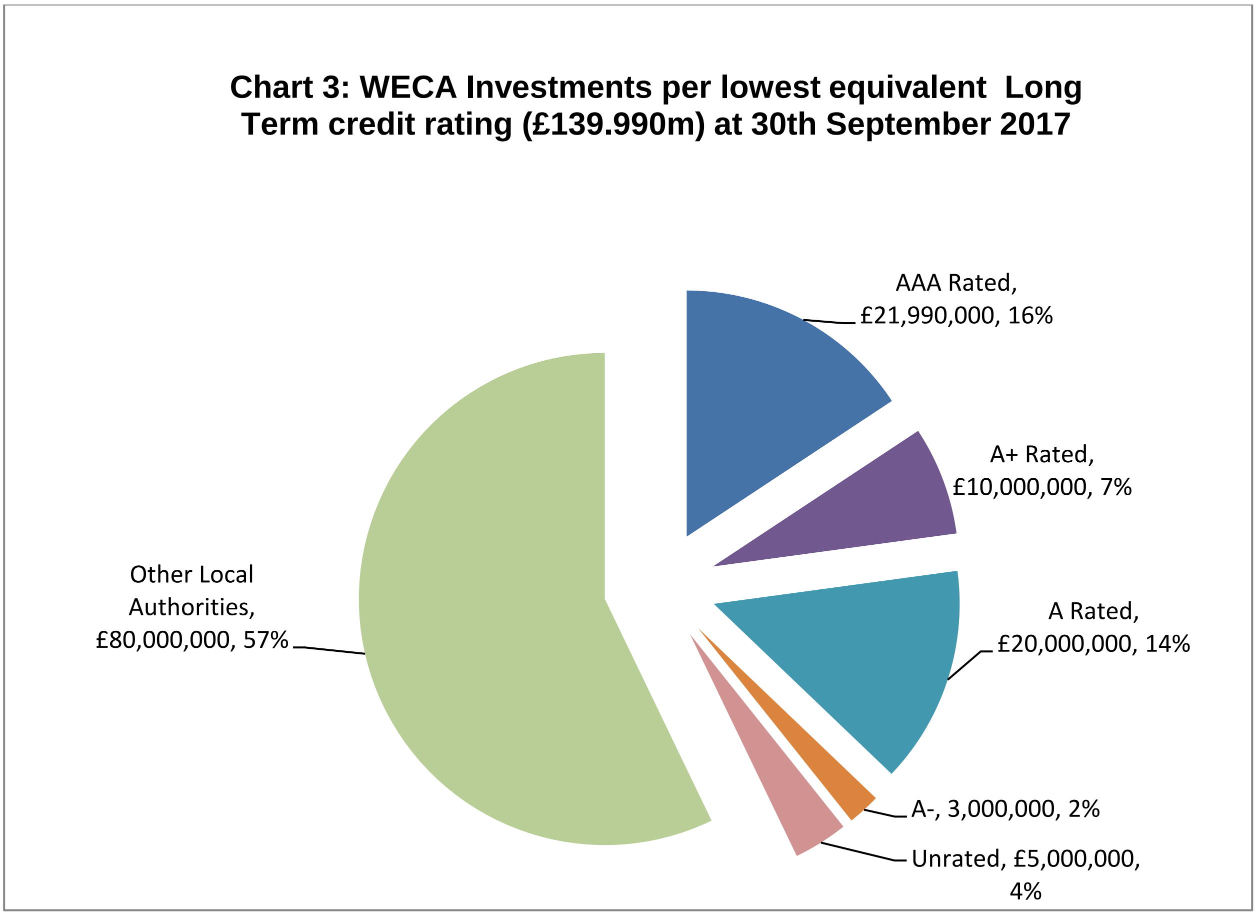


Chart 3: WECA Investments per lowest equivalent Long Term credit rating (£139.990m) at 30th September 2017
AAA Rated, £21,990,000, 16%
A+ Rated, £10,000,000, 7%
A Rated, £20,000,000, 14%
A-, 3,000,000, 2%
Unrated, £5,000,000, 4%
Other Local Authorities, £80,000,000, 57%

APPENDIX 3

Average rate of return on investments for 2017/18.

	April %	May %	June %	July %	Aug %	Sep %	Average for Period %
Average rate of interest earned	0.40	0.44	0.43	0.41	0.41	0.41	0.42
Benchmark = Average 7 Day LIBID rate +0.05% (source: Arlingclose)	0.16	0.16	0.16	0.16	0.16	0.16	0.16
Difference from Benchmark %	+0.24	+0.28	+0.27	+0.25	+0.25	+0.25	+0.26

APPENDIX 4

Authorities External Borrowing at 30th September 2017

*There is no current borrowing.

APPENDIX 5

<u>Economic and market review for April to September 2017 (provided by Arlingclose)</u>

Economic backdrop: Commodity prices fluctuated over the period with oil falling below $45 a barrel before inching back up to $58 a barrel. UK Consumer Price Inflation (CPI) index rose with the data print for August showing CPI at 2.9%, its highest since June 2013 as the fall in the value of sterling following the June 2016 referendum result continued to feed through into higher import prices. The new inflation measure CPIH, which includes owner occupiers' housing costs, was at 2.7%.

The unemployment rate fell to 4.3%, its lowest since May 1975, but the squeeze on consumers intensified as average earnings grew at 2.5%, below the rate of inflation. Economic activity expanded at a much slower pace as evidenced by Q1 and Q2 GDP growth of 0.2% and 0.3% respectively. With the dominant services sector accounting for 79% of GDP, the strength of consumer spending remains vital to growth, but with household savings falling and real wage growth negative, there are concerns that these will be a constraint on economic activity in the second half of calendar 2017.

The Bank of England made no change to monetary policy at its meetings in the first half of the financial year. The vote to keep Bank Rate at 0.25% narrowed to 5-3 in June highlighting that some MPC members were more concerned about rising inflation than the risks to growth. Although at September's meeting the Committee voted 7-2 in favour of keeping Bank Rate unchanged, the MPC changed their rhetoric, implying a rise in Bank Rate in "the coming months". The Council's treasury advisor Arlingclose is not convinced the UK's economic outlook justifies such a move at this stage, but the Bank's interpretation of the data seems to have shifted.

In contrast, near-term global growth prospects improved. The US Federal Reserve increased its target range of official interest rates in June for the second time in 2017 by 25bps (basis points) to between 1% and 1.25% and, despite US inflation hitting a soft patch with core CPI at 1.7%, a further similar increase is expected in its December 2017 meeting. The Fed also announced confirmed that it would be starting a reversal of its vast Quantitative Easing programme and reduce the $4.2 trillion of bonds it acquired by initially cutting the amount it reinvests by $10bn a month.

Geopolitical tensions escalated in August as the US and North Korea exchanged escalating verbal threats over reports about enhancements in North Korea's missile programme. The provocation from both sides helped wipe off nearly $1 trillion from global equity markets but benefited safe-haven assets such as gold, the US dollar and the Japanese yen. Tensions remained high, with North Korea's threat to fire missiles towards the US naval base in Guam, its recent missile tests over Japan and a further testing of its latent nuclear capabilities.

Prime Minister Theresa May called an unscheduled General Election in June, to resolve uncertainty but the surprise result has led to a minority Conservative government in coalition with the Democratic Unionist Party. This clearly results in an enhanced level of political uncertainty. Although the potential for a so-called hard Brexit is diminished, lack of clarity over future trading partnerships, in particular future customs agreements with the rest of the EU block, is denting business sentiment and investment. The reaction from the markets on the UK election's outcome was fairly muted, business confidence now hinges on the progress (or not) on Brexit negotiations, the ultimate 'divorce bill' for the exit and whether new trade treaties and customs arrangements are successfully concluded to the UK's benefit.

In the face of a struggling economy and Brexit-related uncertainty, Arlingclose expects the Bank of England to take only a very measured approach to any monetary policy tightening, any increase will be gradual and limited as the interest rate backdrop will have to provide substantial support to the UK economy through the Brexit transition.

Financial markets: Gilt yields displayed significant volatility over the six-month period with the appearing change in sentiment in the Bank of England's outlook for interest rates, the push-pull from expectations of tapering of Quantitative Easing (QE) in the US and Europe and from geopolitical tensions, which also had an impact. The yield on the 5-year gilts fell to 0.35% in mid-June, but then rose to 0.80% by the end of September. The 10-year gilts similarly rose from their lows of 0.93% to 1.38% at the end of the quarter, and those on 20-year gilts from 1.62% to 1.94%.

The FTSE 100 nevertheless powered away reaching a record high of 7548 in May but dropped back to 7377 at the end of September. Money markets rates have remained low: 1-month, 3-month and 12-month LIBID rates have averaged 0.25%, 0.30% and 0.65% over the period from January to 21st September.

Credit background: UK bank credit default swaps continued their downward trend, reaching three-year lows by the end of June. Bank share prices have not moved in any particular pattern.

There were a few credit rating changes during the quarter. The significant change was the downgrade by Moody's to the UK sovereign rating in September from Aa1 to Aa2 which resulted in subsequent downgrades to sub-sovereign entities including local authorities. Moody's downgraded Standard Chartered Bank's long-term rating to A1 from Aa3 on the expectation that the bank's profitability will be lower following management's efforts to de-risk their balance sheet. The agency also affirmed Royal Bank of Scotland's and NatWest's long-term ratings at Baa1, placed Lloyds Bank's A1 rating on review for upgrade, revised the outlook of Santander UK plc, and Nationwide and Coventry building societies from negative to stable but downgraded the long-term rating of Leeds BS from A2 to A3.

S&P also revised Nordea Bank's outlook to stable from negative, whilst affirming their long-term rating at AA-. The agency also upgraded the long-term rating of ING Bank from A to A+.

Ring-fencing, which requires the larger UK banks to separate their core retail banking activity from the rest of their business, is expected to be implemented within the next year. In May, following Arlingclose's advice, the Authority reduced the maximum duration of unsecured investments with Bank of Scotland, HSBC Bank and Lloyds Bank from 13 months to 6 months as until banks' new structures are finally determined and published, the different credit risks of the 'retail' and 'investment' banks cannot be known for certain.

The new EU regulations for Money Market Funds 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 NAV (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 converting to the LVNAV structure and awaits confirmation from each fund.

Regulatory Updates: MiFID II: Local authorities are currently treated by regulated financial services firms as professional clients who can "opt down" to be treated as retail clients instead. But from 3rd January 2018, as a result of the second Markets in Financial Instruments Directive (MiFID II), local authorities will be treated as retail clients who can "opt up" to be professional clients, providing that they meet certain criteria. Regulated financial services firms include banks, brokers, advisers, fund managers and custodians, but only where they are selling, arranging, advising or managing designated investments. In order to opt up to professional, the authority must have an investment balance of at least £10 million and the person authorised to make investment decisions on behalf of the authority must have at least one year's relevant professional experience. In addition, the firm must assess that that person has the expertise, experience and knowledge to make investment decisions and understand the risks involved.

The main additional protection for retail clients is a duty on the firm to ensure that the investment is "suitable" for the client. However, local authorities are not protected by the Financial Services Compensation Scheme nor are they eligible to complain to the Financial Ombudsman Service whether they are retail or professional clients. It is also likely that retail clients will face an increased cost and potentially restricted access to certain products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice. The Authority has declined to opt down to retail client status in the past as the costs were thought to outweigh the benefits.

The Authority meets the conditions to opt up to professional status and intends to do so in order to maintain their current MiFID status.

CIPFA Consultation on Prudential and Treasury Management Codes: In February 2017 CIPFA canvassed views on the relevance, adoption and practical application of the Treasury Management and Prudential Codes and after reviewing responses launched a further consultation on changes to the codes in August with a deadline for responses of 30th September 2017.

The proposed changes to the Prudential Code include the production of a new high-level Capital Strategy report to full council which will cover the basics of the capital programme and treasury management. The prudential indicators for capital expenditure and the authorised borrowing limit would be included in this report but other indicators may be delegated to another committee. There are plans to drop certain prudential indicators, however local indicators are recommended for ring fenced funds (including the HRA) and for group accounts. Other proposed changes include applying the principles of the Code to subsidiaries.

Proposed changes to the Treasury Management Code include the potential for non-treasury investments such as commercial investments in properties in the definition of "investments" as well as loans made or shares brought for service purposes. Another proposed change is the inclusion of financial guarantees as instruments requiring risk management and addressed within the Treasury Management Strategy. Approval of the technical detail of the Treasury Management Strategy may be delegated to a committee rather than needing approval of full Council. There are also plans to drop or alter some of the current treasury management indicators.

CIPFA intends to publish the two revised Codes towards the end of 2017 for implementation in 2018/19, although CIPFA plans to put transitional arrangements in place for reports that are required to be approved before the start of the 2018/19 financial year. The Department of Communities and Local Government (DCLG) and CIPFA wish to have a more rigorous framework in place for the treatment of commercial investments as soon as is practical. It is understood that DCLG will be revising its Investment Guidance (and its MRP guidance) for local authorities in England; however there have been no discussions with the devolved administrations yet.

Outlook for the remainder of 2017/18

The UK economy faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. Both consumer and business confidence remain subdued. Household consumption growth, the driver of UK GDP growth, has softened following a contraction in real wages. Savings rates are at an all-time low and real earnings growth (i.e after inflation) struggles in the face of higher inflation.

The Bank of England's Monetary Policy Committee has changed its rhetoric, implying a rise in Bank Rate in "the coming months". Arlingclose is not convinced the UK's economic outlook justifies such a move at this stage, but the Bank's interpretation of the data seems to have shifted.

This decision is still very data dependant and Arlingclose is, for now, maintaining its central case for Bank Rate at 0.25% whilst introducing near-term upside risks to the forecast as shown below. Arlingclose's central case is for gilt yields to remain broadly stable in the across the medium term, but there may be near term volatility due to shifts in interest rate expectations.

APPENDIX 6

Interest & Capital Financing Costs – Budget Monitoring 2017/18 (Apr to September)

April to September 2017	YEAR END FORECAST Budgeted Spend or (Income) £'000	Forecast Spend or (Income) £'000	Forecast over or (under) spend £'000	ADV/FAV
Interest & Capital Financing				
- Debt Costs	0	0	0	
- Interest on Balances	(90)	(300)	(210)	
Sub Total - Capital Financing	**(90)**	**(300)**	**(210)**	

APPENDIX 7

Summary Guide to Credit Ratings

Rating	Details
AAA	Highest credit quality – lowest expectation of default, which is unlikely to be adversely affected by foreseeable events.
AA	Very high credit quality - expectation of very low default risk, which is not likely to be significantly vulnerable to foreseeable events.
A	High credit quality - expectations of low default risk which may be more vulnerable to adverse business or economic conditions than is the case for higher ratings.
BBB	Good credit quality - expectations of default risk are currently low but adverse business or economic conditions are more likely to impair this capacity.
BB	Speculative - indicates an elevated vulnerability to default risk, particularly in the event of adverse changes in business or economic conditions over time.
B	Highly speculative - indicates that material default risk is present, but a limited margin of safety remains. Capacity for continued payment is vulnerable to deterioration in the business and economic environment.
CCC	Substantial credit risk - default is a real possibility.
CC	Very high levels of credit risk - default of some kind appears probable.
C	Exceptionally high levels of credit risk - default is imminent or inevitable.
RD	Restricted default - indicates an issuer that has experienced payment default on a bond, loan or other material financial obligation but which has not entered into bankruptcy filings, administration, receivership, liquidation or other formal winding-up procedure, and which has not otherwise ceased operating.
D	Default - indicate san issuer that has entered into bankruptcy filings, administration, receivership, liquidation or other formal winding-up procedure, or which has otherwise ceased business.