ITEM: 10

REPORT TO: WECA AUDIT COMMITTEE

DATE: 12th July 2018

REPORT TITLE: TREASURY MANAGEMENT OUTTURN REPORT 2017/18

AUTHOR: TIM RICHENS, INTERIM DIRECTOR OF INVESTMENT AND CORPORATE SERVICES

Appendix 1 – Performance Against Prudential Indicators
Appendix 2 – The Authority's Investment Position at 31 March 2018
Appendix 3 – Average monthly rate of return for 2017/18
Appendix 4 – The Authority's External Borrowing Position at 31 March 2018
Appendix 5 – Arlingclose's Economic & Market Review for 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 31st March 2018.

2.0 ISSUES FOR CONSIDERATION

SUMMARY

2.1 The average rate of investment return for 2017/18 is 0.53%, which is 0.27% 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 31st March 2018 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 2017/18 totalled £688k. Interest earned for RIF and LGF is ringfenced to those funds, giving rise to an income outturn of £372K, mainly arising from Gainshare. **Appendix 3** details the investment performance, showing the average rate of interest earned over this period was 0.53%, which was 0.27% above the benchmark rate of average 7 day LIBID +0.05% (0.26%). 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 £89m The Authority also uses AAA rated Money Market funds to maintain very short-term liquidity with £28.820m invested in Money Market Funds as at 31st March 2018.

2.9 The Authority purchased further units in the CCLA Property Fund to increase its investment from £5m to £9,956,738 through successfully bidding for another Council's investment who wanted to sell, the saving from offer price being £190K. This investment seeks to enhance yields, provide diversification and 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 0.53% 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 2017/18 – attached at **Appendix 5**.

2.13 5.16 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 the MPC has stopped short of committing itself to the timing of the next increase in

2.14 From 3rd January 2018, as a result of the second Markets in Financial Instruments Directive (MiFID II, the Authority has "opted" up to professional status to continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

3.0 FINANCIAL IMPLICATIONS

3.1 A breakdown of the revenue budget for interest and the year end outturn position is included in **Appendix 6**.

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 Audit Committee is recommended to:

9.1 Note the Treasury Management Report to 31st March 2018, prepared in accordance with the CIPFA Treasury Code of Practice

9.2 Note the Treasury Management Indicators to 31st March 2018

WECA Contact: Tim Richens, Interim Director of Investment and Corporate Services

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 31st March2018**
	£'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 31st March2018**
	£'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 31st March2018**
	%	%
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 31st March2018
	%	%
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 31st March2018
	%	%
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 31st March2018
	%	%	%
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**. The figure excludes Property Fund Investment.

	2017/18 Prudential Indicator	Actual as at 31st March2018
	Rating	Rating
Minimum Portfolio Average Credit Rating	**A-**	**AAA**

APPENDIX 2

The Authority's Investment position at 31st March 2018.

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

	Balance at 31st March 2018
	£'000's
Notice (instant access funds)	28,820
Up to 1 month	35,000
1 month to 3 months	22,000
4 to 6 months	10,000
6 to 12 months	22,000
Property Fund	9,956,738
Total	**127,777**

The Authority had a total average net positive balance of £133.5m during the period January to March 2018 .

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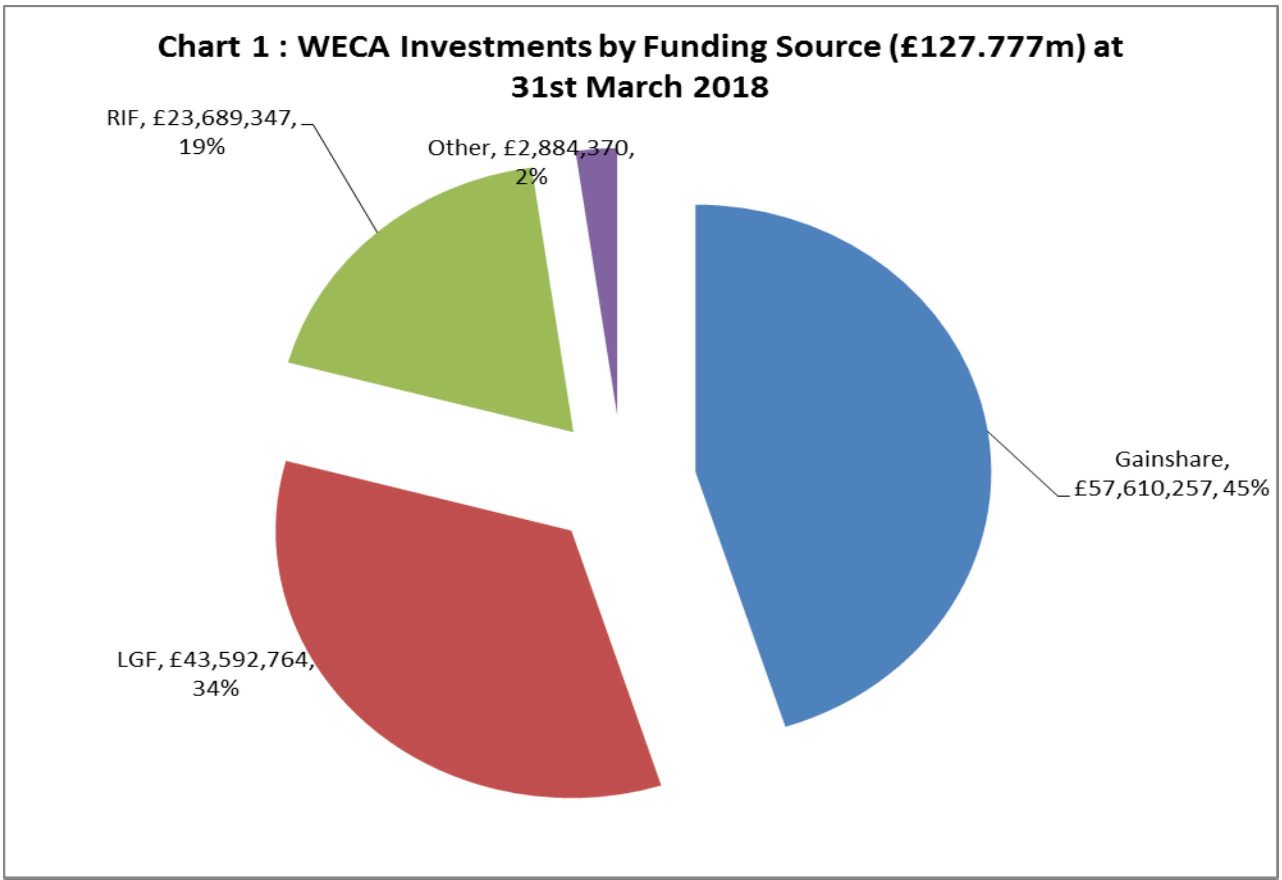


Chart 1 : WECA Investments by Funding Source (£127.777m) at 31st March 2018
RIF, £23,689,347, 19%
Other, £2,884,370, 2%
Gainshare, £57,610,257, 45%
LGF, £43,592,764, 34%

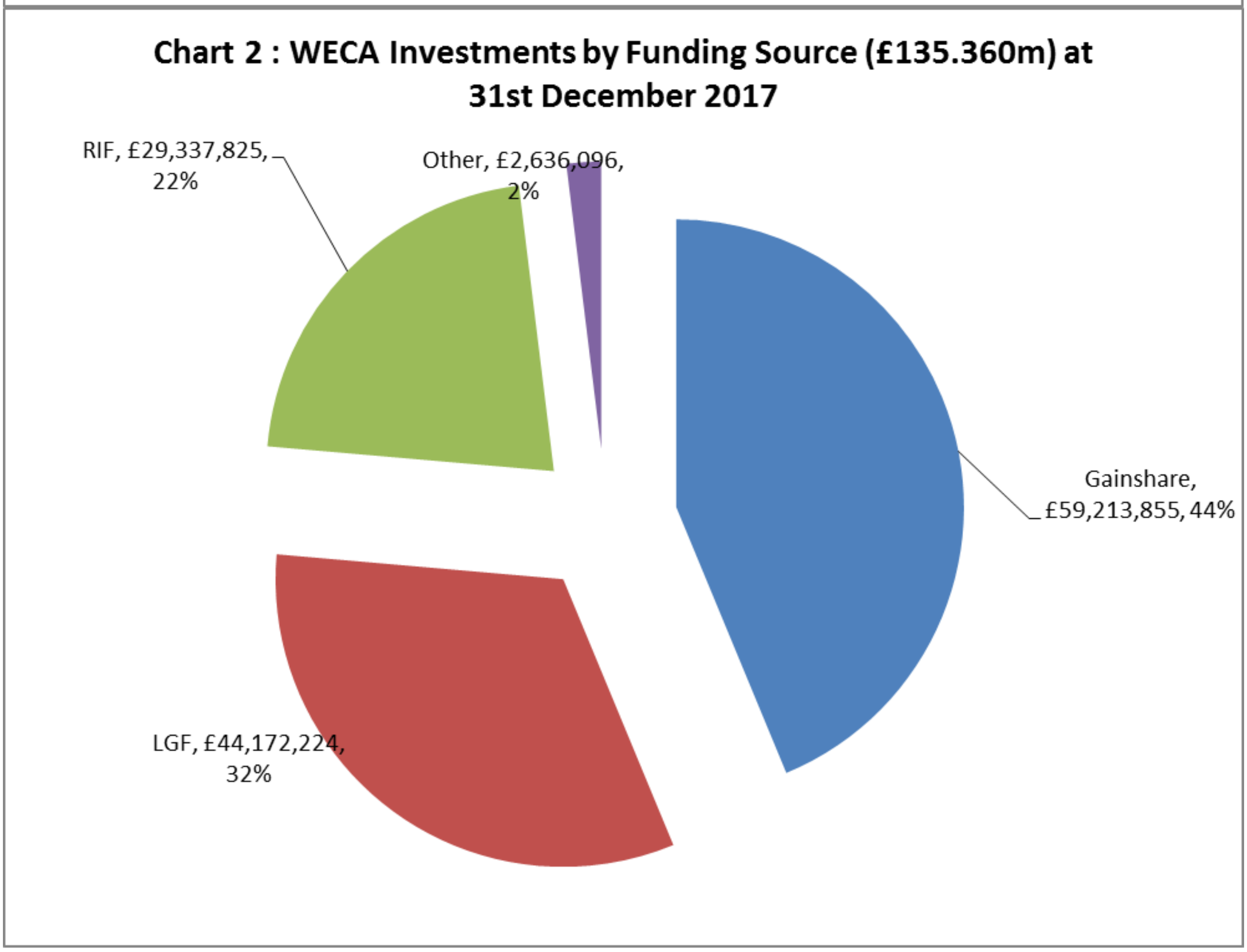


Chart 2 : WECA Investments by Funding Source (£135.360m) at 31st December 2017
RIF, £29,337,825, 22%
Other, £2,636,096, 2%
Gainshare, £59,213,855, 44%
LGF, £44,172,224, 32%

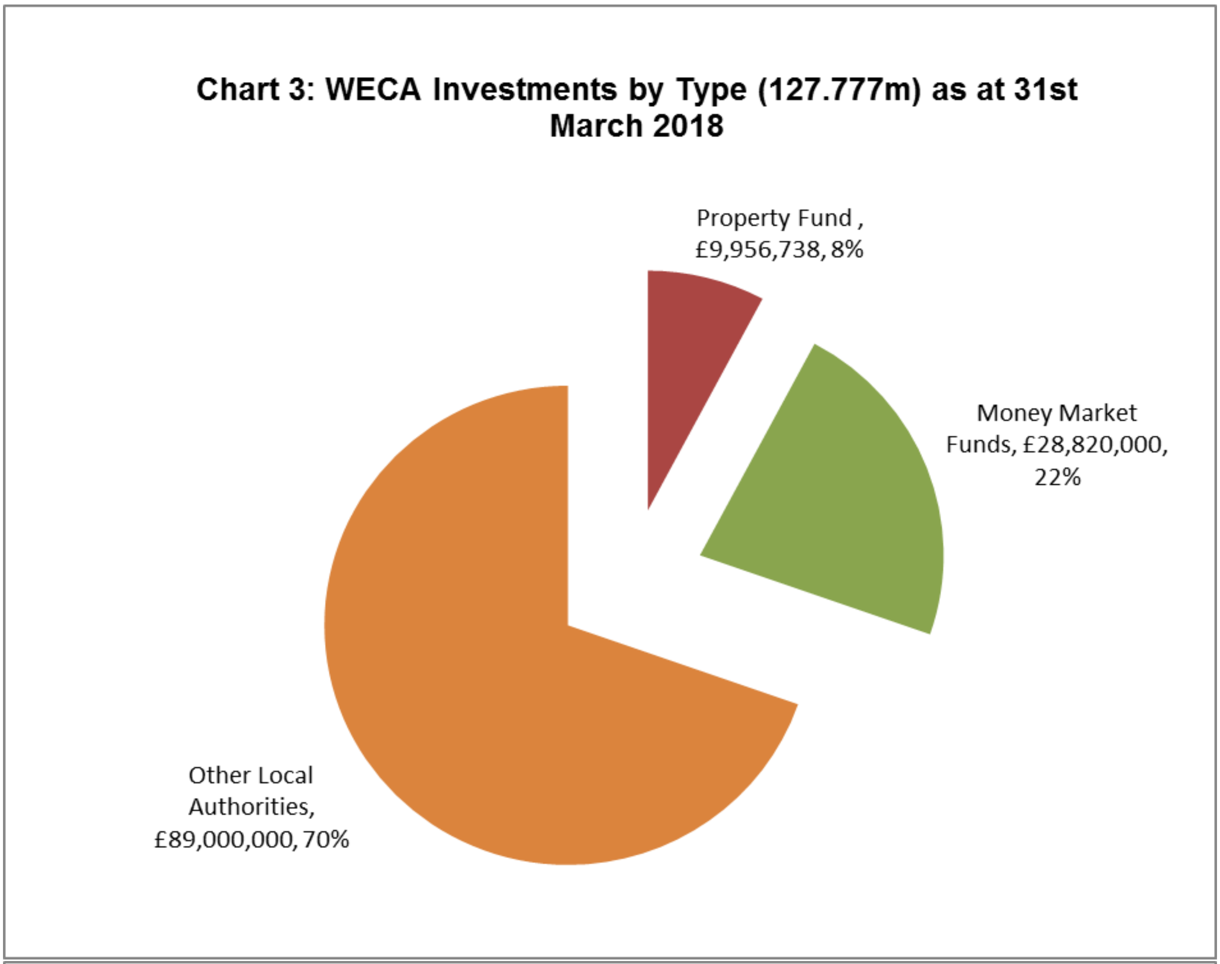


Chart 3: WECA Investments by Type (127.777m) as at 31st March 2018
Property Fund , £9,956,738, 8%
Money Market Funds, £28,820,000, 22%
Other Local Authorities, £89,000,000, 70%

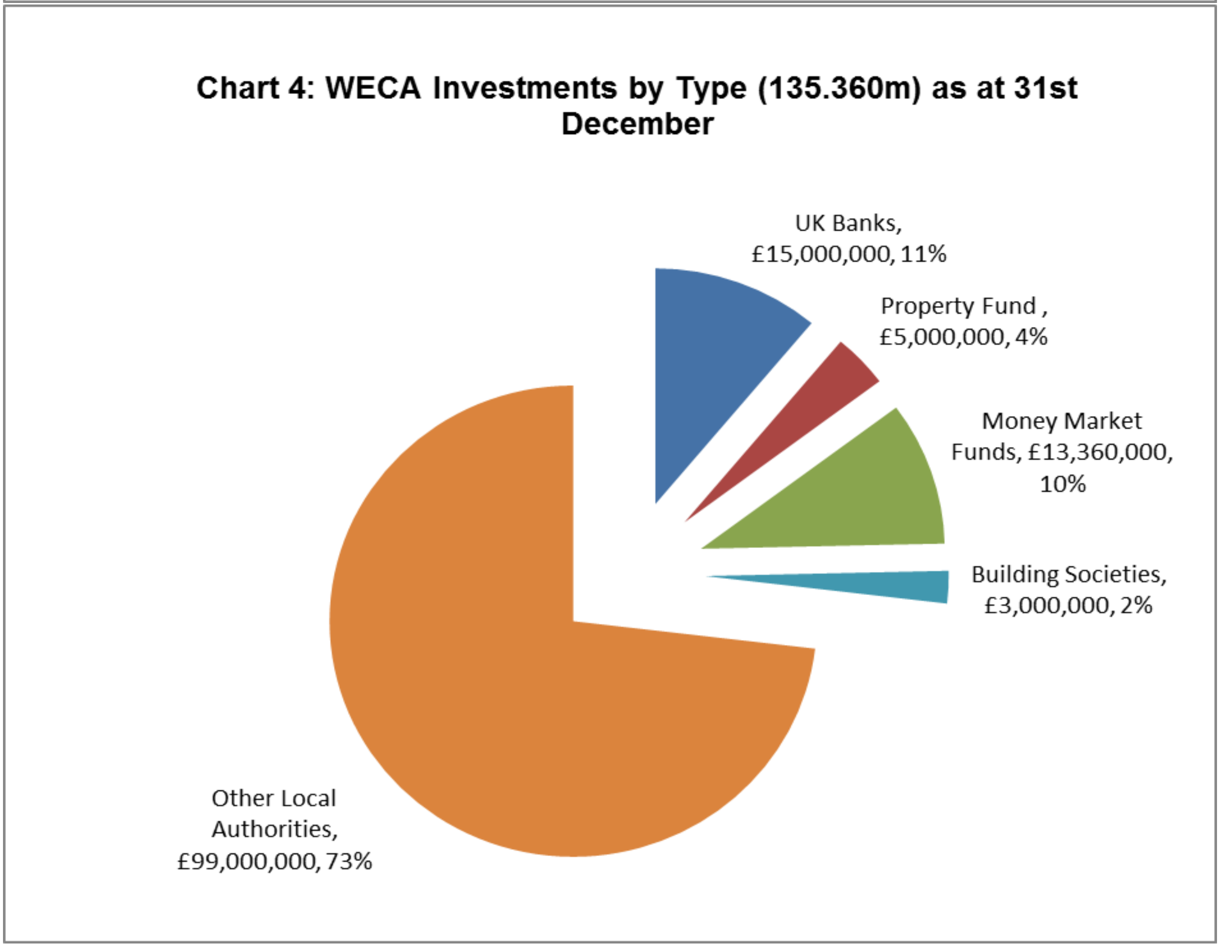


Chart 4: WECA Investments by Type (135.360m) as at 31st December
UK Banks, £15,000,000, 11%
Property Fund , £5,000,000, 4%
Money Market Funds, £13,360,000, 10%
Building Societies, £3,000,000, 2%
Other Local Authorities, £99,000,000, 73%

Chart 5: WECA Investments per lowest equivalent Long Term credit rating (£127.777m) at 31th March 2018

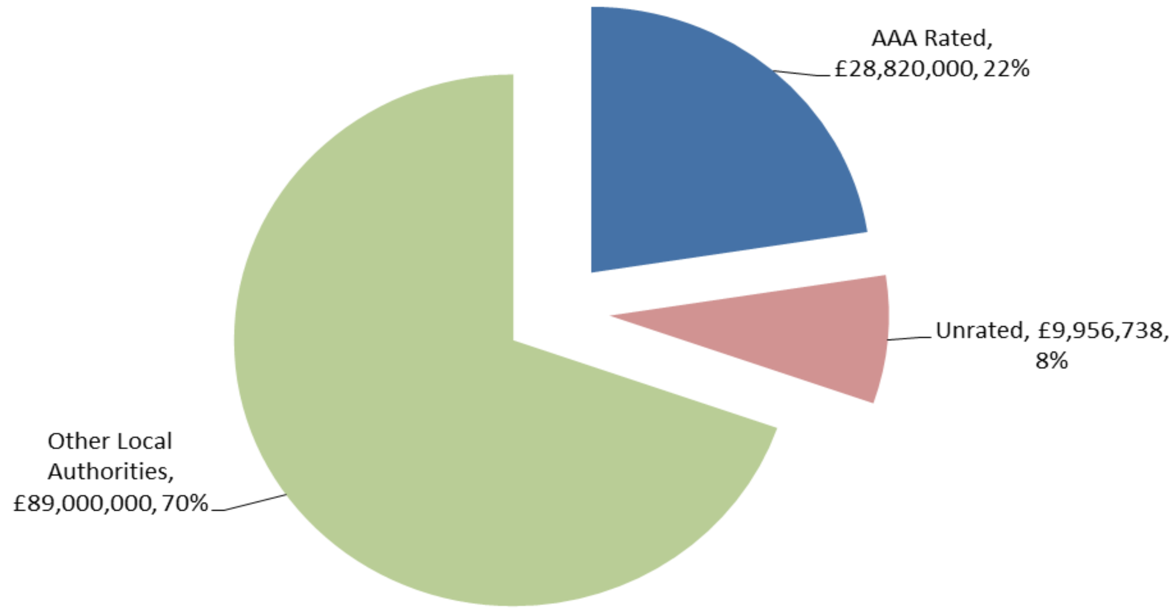
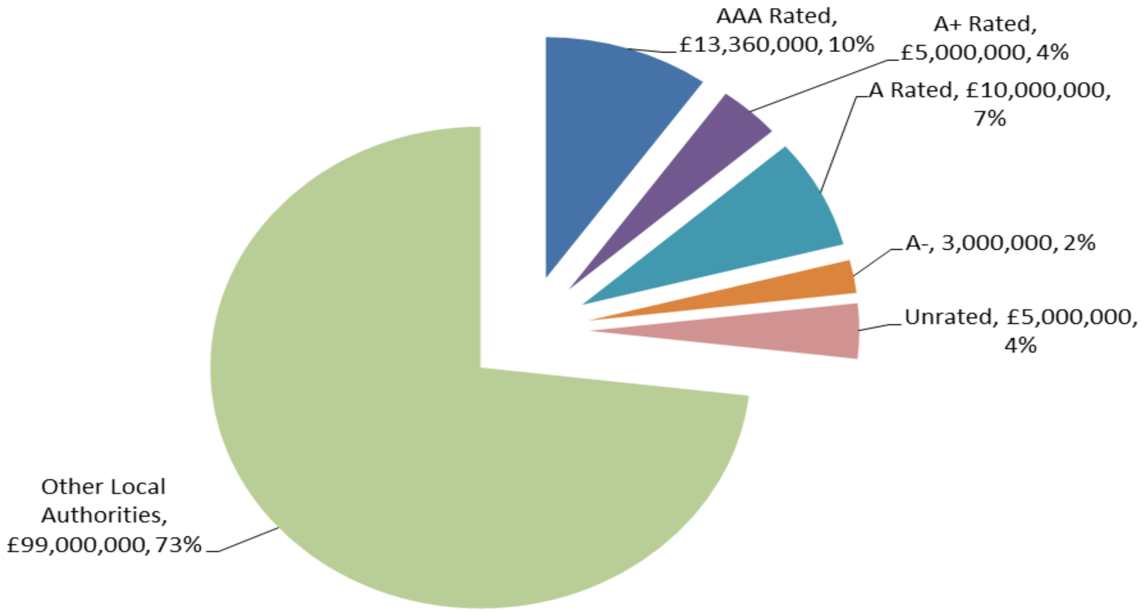


Chart 6: WECA Investments per lowest equivalent Long Term credit rating (£135.360m) at 31th December 2017



APPENDIX 3

Average rate of return on investments for 2017/18.

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

	Oct %	Nov %	Dec %	Jan %	Feb %	Mar %	Average for Period %
Average rate of interest earned	0.57	0.58	0.65	0.67	0.69	0.68	0.53
Benchmark = Average 7 Day LIBID rate +0.05% (source: Arlingclose)	0.17	0.40	0.41	0.41	0.41	0.41	0.26
Difference from Benchmark %	+0.40	+0.18	+0.24	0.26	0.28	0.27	+0.27

APPENDIX 4

Authorities External Borrowing at 31th March2018

*There is no current borrowing.

APPENDIX 5

Economic and market review for April to 31st March 2018 (provided by Council's Treasury Advisors Arlingclose)

Economic commentary

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.

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.

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.

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 likely. (which subsequently this has been postponed).

In contrast, economic activity in the Eurozone gained momentum and although the European Central Bank removed reference to an 'easing bias' in its market communications and had yet to confirm its QE intention when asset purchases end in September 2018, the central bank appeared some way off normalising interest rates. The US economy grew steadily and, with its policy objectives of price stability and maximising employment remaining on track, the Federal Reserve Open Market Committee (FOMC) increased interest rates in December 2017 by 0.25% and again in March, raising the policy rate target range to 1.50% - 1.75%. The Fed is expected to deliver two more increases in 2018 and a further two in 2019. However, the imposition of tariffs on a broadening range of goods initiated by the US, which has led to retaliation by China, could escalate into a deep-rooted trade war having broader economic consequences including inflation rising rapidly, warranting more interest rate hikes.

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.

Gilt yields displayed significant volatility over the twelve-month period with the change in sentiment in the Bank of England's outlook for interest rates. The yield on the 5-year gilts which had fallen to 0.35% in mid-June rose to 1.65% by the end of March. 10-year gilt yields also rose from their lows of 0.93% in June to 1.65% by mid-February before falling back to 1.35% at year-end. 20-year gilt yields followed an even more erratic path with lows of 1.62% in June, and highs of 2.03% in February, only to plummet back down to 1.70% by the end of the financial year.

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

In the first quarter of the financial year, UK bank credit default swaps reached three-year lows on the announcement that the Funding for Lending Scheme, which gave banks access to cheaper funding, was being extended to 2018. For the rest of the year, CDS prices remained broadly flat.

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 will be dealing with once ring-fencing was implemented and what the balance sheets of the ring-fenced and non ring-fenced entities would look 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.

Barclays was the first to complete its ring-fence restructure over the 2018 Easter weekend; wholesale deposits including local authority deposits will henceforth be accepted by Barclays Bank plc (branded Barclays International), which is the non ring-fenced bank.

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.

Credit Rating developments

The most 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.

Changes to credit ratings included Moody's downgrade of Standard Chartered Bank's long-term rating to A1 from Aa3 and the placing of UK banks' long-term ratings on review to reflect the impending ring-fencing of retail activity from investment banking (Barclays, HSBC and RBS were on review for downgrade; Lloyds Bank, Bank of Scotland and National Westminster Bank were placed on review for upgrade).

Standard & Poor's (S&P) revised upwards the outlook of various UK banks and building societies to positive or stable and simultaneously affirmed their long and short-term ratings, reflecting the institutions' resilience, progress in meeting regulatory capital requirements and being better positioned to deal with uncertainties and potential turbulence in the run-up to the UK's exit from the EU in March 2019. The agency upgraded Barclays Bank's long-term rating to A from A- after the bank announced its plans for its entities post ring-fencing.

Fitch revised the outlook on Nationwide Building Society to negative and later downgraded the institution's long-term ratings due to its reducing buffer of junior debt. S&P revised the society's outlook from positive to stable.

S&P downgraded Transport for London to AA- from AA following a deterioration in its financial position.

Local Authority Regulatory Changes

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.

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 Council, 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. The Authority expects to produce this in the near future.

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 is be identified and reported.

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).

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.

The definition of prudent MRP has been changed to "put aside revenue over time to cover the 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.

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.

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.

APPENDIX 6

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

April to March 2018	YEAR END FORECAST Budgeted Spend or (Income) £'000	Outturn Spend or (Income) £'000	Forecast over or (under) spend £'000	ADV/FAV
Interest & Capital Financing				
- Debt Costs	0	0	0	N/A
- Interest on Balances	(90)	(372)	(282)	FAV
Sub Total - Capital Financing	**(90)**	**(372)**	**(282)**	**FAV**

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.