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Agenda Item 10.3

Board Meeting

Date	9 December 2016
Report title	Treasury Management Strategy Mid-Year Report 2016/17
Portfolio Lead	Councillor Izzi Seccombe – Finance and Investment
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Report to be/has been considered by	N/A

Recommendation(s) for action or decision:

The Combined Authority Board is recommended to:

1. Note the results of the Treasury Management Strategy as at 30 September 2016.

2. Note that the Authority's borrowing is within the prudential indicators established at the beginning of the year as outlined in appendix 2.

1. Purpose

1.1 The report provides a mid-year update on the West Midlands Combined Authority Treasury Management Strategy and is a being submitted as a requirement under the CIPFA Treasury Management Code.

2. Background

2.1 The Chartered Institute of Public Finance and Accountancy's Treasury Management Code (CIPFA's TM Code) requires that authorities report on the performance of the treasury management function at least twice yearly (mid-year and at year end).

2.2 The Authority's Treasury Management Strategy for 2016/17 was endorsed by WMCA shadow board on 10th June 2016 and ratified at the inauguration meeting on 17th June 2016.

2.3 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. This report covers treasury activity and the associated monitoring and control of risk.

2.4 The daily management of WMCA's cash resources is overseen by the WMCA Treasury Management Group, consisting of the WMCA Section 151 Officer, The Head of Finance, Projects and Programme Accountant and the Business Accountant. The Treasury Management Group is referred to throughout this report.

3. Treasury Management Activity in 2016/17

3.1 External Context – The Economic and Outlook

3.1.1 The preliminary estimate of Quarter 2 2016 GDP showed reasonably strong growth as the economy grew 0.7% quarter-on-quarter, as compared to 0.4% in Quarter 1 and year on year growth running at a healthy pace of 2.2%. However the UK economic outlook changed significantly in June 2016 following the result of the referendum on EU membership which prompted forecasters to revise projections downwards.

3.1.2 The repercussions of June 2016 prompted the Monetary Policy Committee (MPC) to initiate substantial monetary policy easing at its August meeting to mitigate downside risks. This included a cut in Bank Rate to 0.25%, further gilt and corporate bond purchases (Quantative Easing) and cheap funding for banks (Term Funding Scheme) to maintain the supply of credit to the economy. The minutes of the August MPC meeting also suggested that members supported a further cut in Bank Rate to near-zero levels although a further reduction in the near future is considered unlikely unless the economic outlook worsens.

3.1.3 In response to the Bank of England's policy announcement, money market rates and bond yields declined to new record lows. The UK government are expected to follow the example set by the Bank of England with the Autumn Statement (23rd November 2016) likely to witness fiscal initiatives to support economic activity.

3.1.4 Whilst the economic growth consequences of the EU referendum remain speculative, there is uniformity in expectations that uncertainty over the UK's future trade relations with the EU and the rest of the world will adversely affect economic activity, investment and credit availability, potentially prompting a rise in unemployment.

3.1.5 In addition, inflation is expected to increase due to a rise in import prices. The August Quarterly Inflation Report from the Bank of England forecasts a rise in CPI to 0.9% by the end of 2016 and thereafter a rise closer to the Bank's 2% target over the coming year, as previous rises in commodity prices and the sharp depreciation in sterling begin to drive up imported material costs for companies.

3.2 Market Reaction

Following the EU referendum gilt yields (which are directly linked to the cost of new borrowing undertaken by WMCA) fell sharply on the view that Bank Rate would remain extremely low for the foreseeable future. The yield on the 10 year gilts fell from 1.37% in June to a low of 0.52% in August and has since risen to 0.69% at the end of September.

3.2.1 After an initial sharp drop, equity markets appeared to have been largely unaffected by the result of the EU referendum and performed well.

3.2.2 The most noticeable fall in money market rates was for very short-dated periods (overnight to 1 month) where rates fell to between 0.1% and 0.2%

4. Treasury Management Mid-Year Review

5.1 Table 1 shows borrowing and investments held at 1st April 2016 and 30th September 2016. It shows that net borrowing has decreased by £24.54m mostly as a result of the £36.5m Devolution Fund income received during August 2016.

Table 1: Borrowing and Investments				
	Apr 2016 £m	Borrowing Repaid / New Investments £m	Sept 2016 £m	Notes
Borrowing	(172.08)	0.14	(171.93)	Reduction in borrowing due to annuity loan repayments. No new borrowing undertaken
Investments	28.15	24.40	52.55	The net increase in investments is due to the Devoloution Deal grant of £36.5m less reductions in WMCA available cash.
Net Borrowing	(143.93)	24.54	(119.38)	

5.2 Borrowing Activity

5.2.1 The Authority's chief objective when borrowing continues to be striking an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Authority's long-term plans change being a secondary objective.

5.2.2 Affordability and the "cost of carry" remained important influences on the Authority's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing. As short-term interest rates have remained, and are likely to remain for a significant period, lower than long-term rates, the Authority determined it was more cost effective in the short-term to use internal resources instead.

5.2.3 The benefits of internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose (treasury advisors) assists the Authority with this 'cost of carry' and breakeven analysis.

5.3 New Short Term Borrowing Undertaken

5.3.1 Effective cash flow management to-date, and the use of grants received in advance have minimised borrowing. As a result no new short term borrowing has been undertaken to meet working capital requirements during 2016/17. This is partly due to the fact that WMCA treasury management activity is rightly being managed as a whole cash position for the Combined Authority.

5.3.2 In August 2016 WMCA received a full year allocation (£36.5m) of Devolution Deal Grant to fund the approved Investment Programme. In cash terms, TfWM Capital Investment Programme continues to spend and will require some finance funded by 'borrowing' in the latter half of the current financial year. It is likely, however, in order to avoid actually borrowing which would in effect, simply increase the overall funds WMCA have available to invest, the Authority will use available cash resources from its balance sheet and will

notionally recharge the financing cost of the requirement to the Transport Budget in year.

5.4 New Medium to Long Term Borrowing Undertaking

5.4.1 Similarly, effective cash management during the year has meant no additional borrowing has been undertaken in 2016/17 to date.

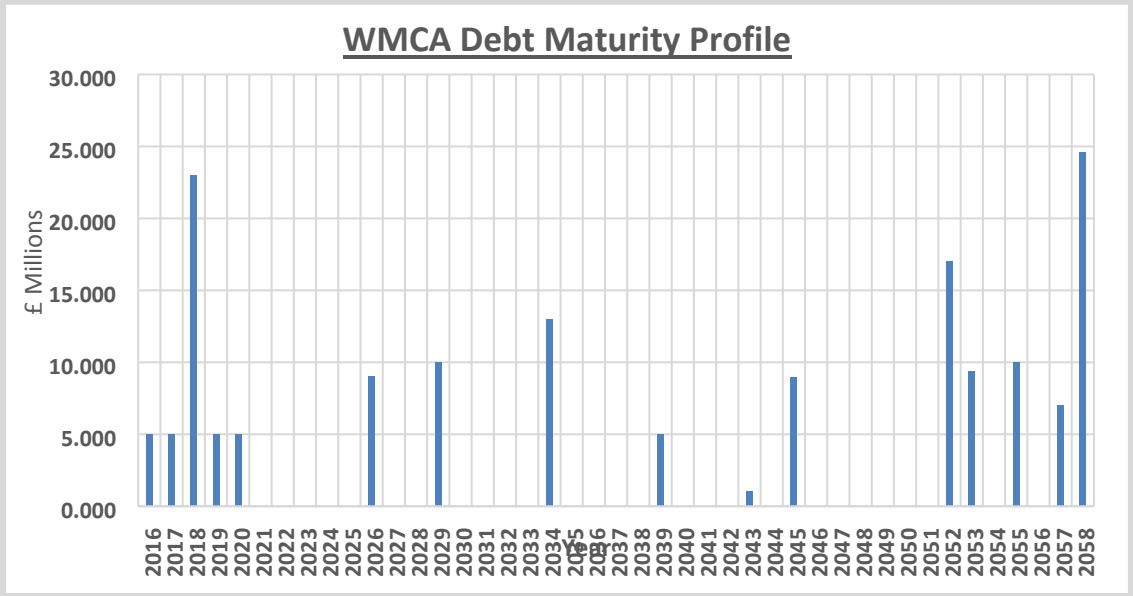
5.5 Historic Borrowing

5.5.1 The main borrowing sources are PWLB (HM Treasury) and money markets. The Treasurer of the Authority continues to review the opportunities to reschedule debt. The costs associated with early repayment have been too onerous to be beneficial. As at the 30th September 2016 there have been no movements in long term debt except the principal repayable during the year on annuity loans. There is a scheduled £5m debt repayment due in December 2016. PWLB borrowing rates are being monitored regularly (see appendix 1) should any debt refinancing be required.

5.5.2 Table 2 shows borrowing held at 1st April 2016 and 30th September 2016. It shows that net borrowing has decreased by £0.144m due principal repayments during the year on annuity loans.

Table 2 - Outstanding debt as at 30th September 2016

	Balance at 1st Apr 2016 £000	Repaid in Year £000	Raised in Year £000	Balance at 30th Sept 2016 £000
PWLB	153,010	(144)	-	**152,866**
LOBO (Barclays Bank)	10,000	-	-	**10,000**
Ex WMCC	9,068	-	-	**9,068**
Total Long Term Borrowing	**172,078**	**(144)**	**-**	**171,934**



5.5.3 It can be seen from the graph above that significant debt repayments are due between 2016 and 2020. These borrowings are likely to need replacing and given historically low long term interest rates, WMCA are monitoring when might be the optimal time to undertake replacement borrowings.

5.5.4 The majority of WMCA borrowing is with PWLB, however the Authority has a LOBO (£10m) over 50 years with Barclays Bank (maturity date June 2055). In June 2016 Barclays decided to permanently waive its right under the lenders option of the LOBO feature to change interest rates in the future. Meaning WMCA loan with Barclays is no longer variable but a fixed term loan. No other term or condition of the loan is amended and will still mature June 2055. The WMCC (West Midlands County Council) debt is due for maturity in 2026 (principal and interest are repaid annually).

5.6 Investment Activity

5.6.1 The Authority holds invested funds, representing income received in advance of expenditure plus balances held. The Guidance on Local Government Investments in England gives priority to security and liquidity and the Authority's aim is to achieve a yield commensurate with these principles.

5.6.2 Given the risk and continued low returns from short-term unsecured bank investments, it is the Authority's aim to diversify into more secure and/or higher yielding asset classes. The majority of the Authority's surplus cash was previously invested in short-term unsecured bank deposits, and money market funds.

5.6.3 Short term investments are split between term deposits, where cash is invested to periods in excess of one day and up to 3 months, and overnights money and call accounts where cash is available instantly. For overnight money and call accounts the Authority has predominately used HSBC Bank plc, HSBC Global Liquidity Fund – Sterling), Santander UK Plc, Barclays Bank, Lloyds Plc.

5.6.4 Fixed term investments are deposits where cash is invested in excess of 3 months.

5.6.5 As at the 30th September 2016, all short term investments have given a return to the Authority of £73,049 in 2016/17 and an average rate of 0.58%, as shown in Table 3 below.

Table 3: Investment Interest		
Period Apr 16 - Sept 16	**Average Rate**	**Investment Interest Earned**
National Counties Building Society	0.80%	£3,419
Newcastle Building Society	0.80%	£3,419
West Bromwich Building Society	0.78%	£3,334
Santander UK plc (call)	0.76%	£35,694
Lloyds Bank Plc (call)	0.54%	£7,672
Lloyds Bank Plc	0.50%	£2,808
HSBC Global Liquidity Fund	0.43%	£11,895
Barclays Bank	0.22%	£1,579
HSBC Bank Plc (call)	0.20%	£3,229
TOTAL		**£73,049**

5.6.6 Despite interest rates being depressed following the vote to leave the EU and yields continuing to fall across all investment types, active cash flow management and investment management has led to WMCA improving on its investment return. This was partially aided by receipt of the Devolution Deal grant of £36.5m on 23rd August 2016. Investments held as at the 30th September 2016 were as set in Table 4 below:

Table 4: Investments & interest rates as at 30th September 2016		
Counterparty	**Interest Rate**	**Principal Invested**
Lloyds Bank Plc	1.00%	£5,000,000
National Counties Building Society	0.80%	£4,000,000
Newcastle Building Society	0.80%	£4,000,000
West Bromwich Building Society	0.78%	£4,000,000
Santander UK plc (call)	0.55%	£15,000,000
Lloyds Bank Plc	0.37%	£5,000,000
HSBC Global Liquidity Fund	0.34%	£15,300,000
HSBC Bank Plc (call)	0.10%	£250,000
TOTAL		**£52,550,000**

5.6.7 It should be noted from the above that the investment with Santander UK Plc above exceeds the parameters set within the Treasury Management Strategy relating to a cap on investments with any single institution; which is currently set at £10m. The decision to exceed this measure was taken by Treasury Management Group following a detailed review of available and preferred counterparties when assessing investment opportunities for the Devolution Deal Grant (£36.5m). It is intended to bring this investment value back in line with Treasury Management Strategy parameters during 2016/17 and to review

the limits for the 2016/17 Treasury Management Strategy to ensure the limits do not restrict WMCA's ability to invest across the counterparty list.

5.6.8 For information, the investment with HSBC Global Liquidity Fund of £15.3m is within the tolerances set within the Treasury Management Strategy as this is a highly diversified money market fund and hence is classed as a lower risk investment.

6 Performance measurement

6.1 The WMCA treasury management function participates in a local benchmarking group which compares WMCA's treasury management performance with other local authorities, to ensure that relative to other local authorities the Authority is achieving a fair investment return without any undue risk. Performance is also regularly reviewed at the monthly Treasury Management Group.

6.2 One of the key requirements in the CIPFA Code of Practice on Treasury Management is the formal introduction of performance measurement relating to investments, debt and capital financing activities. The Prudential Indicators as at 30th September 2016 are shown in Appendix 2. All key prudential indicators are met or complained with.

7 Treasury Management Strategy

7.1 The Treasury Management Strategy for 2016/17 has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practise on Treasury Management. Treasury Management is defined as:

"The management of local authority's investment and cash flows, its banking, money market and capital transactions; effective control of risk associated with those activates; and the pursuit of optimum performance consistent with those risks."

7.2 The Treasury Management Strategy is reviewed regularly and amended throughout the year to reflect changes in the financial markets and the economic climate.

8. Counterparty Ratings

8.1 Security of capital has remained the Authority's main investment objective. This has been maintained by following the Authority's counterparty list policy as set out in the Treasury Management Strategy Statement 2016/17.

8.2 Counterparty credit quality is assessed and monitored with reference to credit ratings (the Authority's minimum long-term counterparty rating is BBB+).

8.3 All three credit rating agencies have reviewed their ratings in the six months to 30th September 2016. Moody's affirmed the ratings of nine UK banks and building societies but revised the outlook to negative for those that it perceived to be exposed to a more challenging operating environment arising from the EU referendum outcome.

8.4 Various indicators of credit risk reacted negatively to the result of the EU referendum on the UK's membership of the European Union. There was no immediate change to Arlingclose's (treasury advisors to WMCA) credit advice on UK banks and building societies as a result of the referendum result. WMCA's advisor believes there is a risk that the uncertainty over the UK's future trading prospects will bring forward the timing of the next UK recession.

8.5 The credit rating and financial resilience of counterparties are being monitored regularly and will be assessed with due regard to other financial information as and when it becomes available. Treasury advisors Arlingclose will continue to update the WMCA Treasury Management Group of any changes, both to the ratings and the maximum level of duration for investments.

9 Minimum Revenue Provision

9.1 The WMCA is required to provide for the repayment of long term capital programme borrowing through a revenue charge (the Minimum Revenue Provision or MRP). Capital Finance Regulations require the approval of an MRP Statement setting out the authority's approach. The current MRP statement is:

- *"For capital expenditure incurred before 1st April 2009 or which in future will be financed by supported borrowing, the WMCA will follow previous practice, with MRP broadly based as being 2% of the underlying Capital Financing Requirement.*

- *From 1st April 2009 for all capital expenditure met from unsupported or prudential borrowing, MRP will be based on the estimated life of the asset or a depreciated calculation."*

- *For the existing Transport Delivery Programme MRP will continue to commence in the year after the scheme becomes operational.*

Options relating to the MRP charge for borrowing linked to the Devolution Deal Investment Programme are currently being evaluated and will be set out in more detail in the 2017/18 Treasury Management Strategy.

10 Prudential Code and Indicators

10.1 The Local Government Act 2003 and the associated CIPFA Prudential Code for the capital finance set the framework for the new local government capital finance system. Authorities are able to borrow whatever sums they see fit to support their capital programmes, subject to them being able to afford the revenue costs. This is a fundamental feature of the current system and requires that the Authority sets and monitors a number of Prudential Indicators (PIs) relating to capital, affordability, external debt, and treasury management

10.2 The Authority's Prudential Indicators for 2016/17 were set out as part of the Treasury Management Strategy, shown in appendix 2. These show that the authority is compliant with Prudential Code and parameters set at the beginning of the year.

Appendix 1

Money Market Data and PWLB Rates

Please note that the PWLB rates below are Standard Rates. WMCA is eligible for the Certainty Rate can borrow at a 0.20% reduction.

Table 1: Bank Rate, Money Market Rates

Date		Bank Rate		O/N LIBID	7-day LIBID	1-month LIBID	3-month LIBID	6-month LIBID	12-month LIBID	2-yr SWAP Bid	3-yr SWAP Bid	5-yr SWAP Bid
01/4/2016		0.50		0.36	0.36	0.39	0.46	0.61	0.88	0.78	0.83	0.98
30/4/2016		0.50		0.36	0.36	0.38	0.47	0.62	0.90	0.86	0.95	1.13
31/5/2016		0.50		0.35	0.37	0.39	0.46	0.61	0.89	0.82	0.92	1.09
30/6/2016		0.50		0.35	0.36	0.39	0.43	0.55	0.80	0.49	0.49	0.60
31/7/2016		0.50		0.15	0.45	0.42	0.52	0.64	0.77	0.47	0.47	0.54
31/8/2016		0.25		0.11	0.18	0.18	0.38	0.54	0.69	0.42	0.42	0.48
30/9/2016		0.25		0.10	0.25	0.45	0.51	0.61	0.74	0.43	0.42	0.47
Minimum		0.25		0.02	0.15	0.18	0.30	0.50	0.66	0.38	0.37	0.42
Average		0.43		0.26	0.37	0.42	0.52	0.66	0.83	0.61	0.64	0.75
Maximum		0.50		0.43	0.55	0.61	0.72	0.83	1.04	0.88	0.99	1.20
Spread		0.25		0.41	0.40	0.43	0.42	0.33	0.38	0.51	0.62	0.78

Table 2: PWLB Borrowing Rates - Fixed Rate, Maturity Loans (Standard Rate)

Change Date	Notice No	1 year	4½-5 yrs	9½-10 yrs	19½-20 yrs	29½-30 yrs	39½-40 yrs	49½-50 yrs
01/4/2016	125/16	1.33	1.82	2.51	3.24	3.33	3.19	3.15
30/4/2016	165/16	1.37	1.95	2.65	3.34	3.40	3.25	3.21
31/5/2016	205/16	1.36	1.93	2.56	3.22	3.27	3.11	3.07
30/6/2016	249/16	1.17	1.48	2.09	2.79	2.82	2.61	2.57
31/7/2016	292/16	1.07	1.31	1.84	2.57	2.65	2.48	2.44
31/8/2016	336/16	1.09	1.23	1.65	2.22	2.29	2.12	2.08
30/9/2016	380/16	1.02	1.20	1.70	2.34	2.43	2.29	2.27
	Low	1.01	1.15	1.62	2.20	2.27	2.10	2.07
	Average	1.20	1.54	2.12	2.81	2.87	2.70	2.67
	High	1.40	2.00	2.71	3.40	3.46	3.31	3.28

APPENDIX 2 - Summary Prudential Indicators

Measure	Mid Year Position £000's	Indicators Reported to WMCA AGM			NOTES
		2016/17 Forecast £000's	2017/18 Forecast £000's	2018/19 Forecast £000's	
Affordability					
Ratio of financing costs to net revenue stream:					
(a) financing costs	14,232	14,814	14,863	14,166	Finance costs are reduced due to effective cash flow management reducing the need to borrow
(b) net revenue stream	161,330	152,330	159,542	158,119	A full year of devoloution deal funding was received vs the expected pro-rate amount in the 16/17 Forecast
Percentage	8.82%	9.72%	9.32%	8.96%	
Estimates of Capital Investment on Income (%)	(1.59%)	(1.20%)	0.03%	(0.44%)	The percentage difference reflects the lower borrowing and incresed income position
Prudence					
Gross borrowing and the capital financing requirement:					
Gross Borrowing (excludes inhereted debt)	**170,733**	**175,081**	186,004	191,953	The reductions in the Capital Financing Requirement and Gross Borrowing requirement in 2016/17 are as a result of a reduction in the expected 2016/17 capital expenditure.
Capital Financing Requirement (Gross borrowing in year 2016/17 must not exceed year CFR in 2018/19)	192,513	196,937	207,934	**213,957**	
Capital Expenditure, External Debt and Treasury Management					
Capital Expenditure	76,450	173,442	42,516	34,972	The reduction in capital spend is largely due to a deferal of Devoloution Deal Investment Programme spend into later years, apecifically in relation to the Land Remediation and Business Innovation Funds
Operational boundary for external debt					
Operational boundary for borrowing	248,733	253,081	264,004	269,953	The reduction in the Operational Boundary is driven by the reduced requirement to borrow in 2016/17
Authorised limit for external debt					
Authorised limit for borrowing	253,733	258,081	269,004	274,953	The reduction in the Authorised Limit is driven by the reduced requirement to borrow in 2016/17
Interest rate exposures					
Upper limit on fixed rate exposures	100%	100%	100%	100%	
Upper limit on variable rate exposures	30%	30%	30%	30%	
Investments longer than 364 days					
Upper limit	8,000	8,000	8,000	8,000	

CIPFA Treasury Management Code?	**Yes**
Has the authority adopted the TM Code?	

Maturity structure of borrowing - limits	Upper Limit '%	Current Level '%
Under 12 Months	20%	3%
12 months and within 24 months	30%	3%
24 months & within 5 years	40%	20%
5 years & within 10 years	60%	0%
10 years & within 20 years	100%	14%
20 years & within 30 years	100%	15%
30 years & within 40 years	100%	22%
40 years & within 50 years	100%	22%