WEST MIDLANDS
COMBINED AUTHORITY

Board Meeting

Date	12 May 2017
Report title	Treasury Management Out-turn 2016 / 2017
Cabinet Member Portfolio Lead	Councillor Izzie Seccombe Warwickshire County Council
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Report to be considered by	WMCA Board

Recommendation(s) for action or decision:

WMCA Board is recommended to:

1. Note the results of the Treasury Management Outturn as at 31 March 2017.

2. Notes the internal investment return for 2016/17 of 0.56% as set out in paragraph 6.1.

3. Note that the Authority's borrowing is within the prudential indicators established at the beginning of the year as outlined in Appendix 1.

1.0 Purpose

1.1 The report provides an update on the West Midlands Combined Authority Treasury Management Outturn 2016/17 and is a being submitted as a requirement under the CIPFA Treasury Management Code.

2.0 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 10 June 2016 and ratified at the inauguration meeting on 17 June 2016. The Treasury Management midyear report was agreed by WMCA Main Board on 9 December 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.

2.5 Investments and borrowing are made directly by the WMCA, with advice from external treasury advisors, Arlingclose Limited.

3.0 Treasury Management Activity in 2016/17

External Context – The Economic and Outlook

3.1 Following the sharp decline in household, business and investor sentiment that was prompted by the unexpected outcome of the referendum on EU membership in Quarter 2, the preliminary estimate of Quarter 3 2016 GDP defied expectations as the economy grew 0.5% quarter-on-quarter, down only slightly from 0.7% in Quarter 2 and year/year growth running at a healthy pace of 2.3%.

3.2 Economic data continued to challenge the current sentiment throughout the quarter. Consumer Price Inflation (CPI) fell to 0.9% in October but rose to 1.2% in November, both predominantly driven by clothing, fuel and hotel prices although the Office for National Statistics (ONS) advised that there was little evidence to link this rise to the decline in the value of sterling. With sterling falling by around 20% with its impact on prices still to follow, according to the ONS, CPI will be close to the Bank of England's target rate of 2% in the

first half of 2017; consistent with the forecasts contained within the Bank's last quarterly *Inflation Report* issued in November 2016.

3.3 After a weak August, British consumer spending increased in Quarter 3. UK retail sales growth surged to a 14-year high in October as consumers kept spending and colder weather boosted clothing sales. According to the British Retail Consortium (BRC), fears over Brexit are likely to reduce sales in the period ahead.

3.4 Labour market data also proved resilient, showing a small rise in the level of unemployment by 10,000, and average earnings dipping slightly, but at 2.3% still delivering real earnings growth although clearly under pressure from higher prices. The UK unemployment rate remained at 4.9%, its lowest level in 11 years.

3.5 At its August meeting, the Bank of England's Monetary Policy Committee (MPC) had stated that the majority of members expected to support a further cut in Bank Rate at one of the MPC's forthcoming meetings during the course of the year. However, in the final calendar quarter of 2016 the MPC kept the Bank Rate unchanged at 0.25% and asset purchases at £435 bn.

3.6 In addition to the above, uncertainty surrounds whether or not the new US President will make good the fiscal, regulatory and policy initiatives / changes which were central to the campaign and, if so, their timing and size and their effect on growth, employment and inflation both domestic and globally.

3.7 Following a strengthening labour market, in a move that was largely anticipated, at its meeting in December, the Federal Reserve's Open Market Committee (FOMC) increased the target range for official interest rates for just the second time in the last decade. The range was increased to between 0.5% and 0.75%, from 0.25% and 0.5%. In the accompanying statement, FOMC Chair Janet Yellen also highlighted the expectation of three further rate hikes in 2017, followed by three hikes in each of 2018 and 2019.

Market reaction

3.8 Following the referendum result, gilt yields (which influence the cost of WMCA borrowing from Treasury) had fallen sharply across the maturity spectrum on the view that Bank Rate would remain extremely low for the foreseeable future. Since September there has been a reversal in longer dated gilt yields which have moved higher, largely due to the MPC revising its earlier forecast that Bank Rate would be dropping to near 0% by the end of 2016. The yield on the 10-year gilt rose from 0.75% at the end of September to 1.24% at the end of December, which is almost back at pre-Brexit levels of 1.37% on 23 June. 20- and 50-year gilt yields have also risen considerably in the third quarter to 1.76% and 1.7% respectively, and are nearly back up to pre-Brexit levels.

3.9 However, this recovery was not realised across all maturities. The 1 year gilt yield dropped from 0.13% at the end of September to -0.004% at the end of

December. The one year gilt yield first went negative at the beginning of December, having only been negative intra-day previously. 2 and 3 year gilt yields have also continued to fall.

3.10 After recovering from an initial sharp drop in Quarter 2, equity markets appear to have continued their rally, although displaying some volatility at the beginning of November following the US presidential election result. The FTSE 100 and FTSE All Share indices closed at 7,142.83 and 3,873.22 respectively on 30 December, up 3.5% and 3.1% over the quarter.

3.11 Money market rates for very short-dated periods (overnight to 1 month) have largely started recovering from a noticeable fall in the previous quarter. 7 day and 1 month LIBID (London Interbank Bid Rate) rates increased by about 0.1%, to 0.35% and 0.61% respectively. Longer-dated periods (6 months to 2 years) also increased by between 10 and 20 basis points; on 30 December the 6-month LIBID rate was 0.64%, 12-month 0.81% and the 2-year swap rate 0.60%.

4.0 Treasury Management Outturn 2016/17

4.1 Table 1 shows WMCA borrowing and investments held at 1 April 2016 and 31 March 2017. It shows that net borrowing has decreased by £27.91m mostly as a result of the £36.5m Devolution Fund income received during August 2016, and debt maturity and repayment of £5.86m.

Table 1: Borrowing and Investments

	1st April 2016 £m	Borrowing Repaid / New Investments £m	31st March 2017 £m	Notes
Borrowing	(172.08)	5.86	(166.22)	Reduction in borrowing due to £5m PWLB loan matured Dec 16, £291k PWLB annuity loan repayments, and £569k Dudley Debt annual principal repayment. No new borrowing undertaken.
Investments	28.15	22.05	50.20	The increase in investments is due to the Devolution Deal grant of £36.5m less utilisation of cash to minimise borrowing requirements.
Net Borrowing	**(143.93)**	**27.91**	**(116.02)**	

5.0 Borrowing Activity

5.1 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 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.

5.3 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.

6.0 New Short Term Borrowing Undertaken

6.1 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.

6.2 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'. 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 internally recharge the financing cost of the requirement to the Transport Budget in year.

7.0 New Medium to Long Term Borrowing Undertaking

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

8.0 Historic Borrowing

8.1 The main borrowing sources are Public Works Loan Board (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. During 2016/17 there has been one PWLB maturity of £5m in December 2016, and some principal repayable during the year on annuity loans. WMCC (West Midlands County Council) annual principal repayment of £569k was made in March 2017.

8.2 Table 2 shows borrowing held at 1 April 2016 and 31 March 2017. It shows that borrowing has decreased by £5.860m due principal repayments during the year.

Table 2 - Outstanding debt as at 31st March 2017				
	Balance at 1st Apr 2016 £000	**Repaid in Year £000**	**Raised in Year £000**	**Balance at 31 March 2017 £000**
PWLB	153,010	(5.291)	-	**147,719**
LOBO (Barclays Bank)	10,000	-	-	**10,000**
Ex WMCC	9,068	(0.569)	-	**8,499**
Total Long Term Borrowing	**172,078**	**(5.860)**	**-**	**166,218**

8.3 The cost of servicing the £166.218m debt was £9.695m during 2016/17 (as summarised below in table 3) which equates to an average annual rate of 5.83%.

Table 3 - Cost of Borrowing	
Debt Source	**Interest Paid 2016 / 2017 £000**
PWLB	8,730
LOBO (Barclays Bank)	403
Ex WMCC	562
TOTAL	**9,695**

9.0 Future borrowing / capital programme

9.1 Table 4 below identifies the funding requirements for the next 3 years. It illustrates that using internal funds and cash investments held by the WMCA, no actual borrowing was undertaken in 2016/2017 (compared to a theoretical requirement of £10.6m). It is expected there will be a need to borrow an additional £57.4m in 2017/18 which is driven by the Devolution Deal Investment Programme underpinned by Gain Share Grant and Business Rates income.

9.2 In addition, debt repayments from maturing loans of £5m in 2017/18 and £23m are due in 2018/19 which will have to be rescheduled.

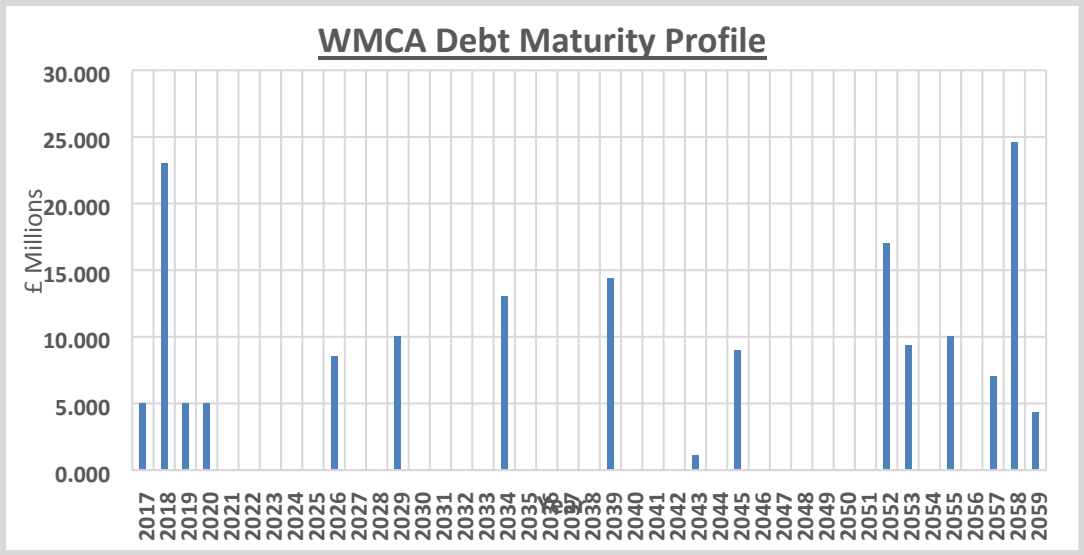
Table 4 : Funding Requirement	2016/17 Actual	2017/18 Forecast	2018/19 Forecast	2019/20 Forecast
TOTAL PROGRAMME / EXPENDITURE	**37,892**	**130,437**	**369,600**	**364,588**
Funded By:				
Department for Transport	7,544	35,065	109,967	135,271
Enterprise Zone Funding	6,091	6,029	30,400	22,000
Local Authority Contributions	322	7,158	6,135	12,929
Local Growth Fund	8,531	15,178	20,004	6,305
Network Rail	-	-	5,100	7,400
3rd Party	126	1,093	5,519	3,400
Central Government Other	-	3,824	-	-
TOTAL FUNDING	**22,614**	**68,347**	**177,125**	**187,305**
BALANCE FUNDED BY LOCAL RESOURCES	**15,278**	**62,090**	**192,475**	**177,283**
Local Resources:				
MRP	4,590	4,646	5,752	9,154
Borrowing	10,688	57,444	186,723	168,129
TOTAL FUNDED BY LOCAL RESOURCES	**15,278**	**62,090**	**192,475**	**177,283**

10.0 Long Term Debt Profile

10.1 It can be seen from table 5 and the graph below that significant debt repayments are due between 2017 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. The debt maturity profile of the loans show that after 2020 the next major repayments do not occur until 2034.

Table 5 - Debt Maturity Profile

	Value of Loans Maturing £m
Repayable 2017/18	6
Repayable 2018/19	24
RepayableBetween2019/20 to 2020/21	12
RepayableBetween2021/22 to 2022/13	3
RepayableBetween2023/24 to 2026/27	5
RepayableBetween2027/28 to 2030/31	12
RepayableBetween2031/32 to 2039/40	23
RepayableBetween2039/40 to 2048/49	11
RepayableBetween2049/50 to 2059/60	70
TOTAL BORROWING	**166**



10.2 As stated in Section 5 any new borrowing will depend upon the prevailing interest rates at the time, and the forecast cash requirements, as to whether it should be short term or long term.

10.3 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).

11.0 PWLB Certainty Rate

11.1 The Certainty Rate was introduced by the PWLB in November 2012, allowing the authority to borrow at a reduction of 20 base points (bps) on the standard PWLB rate. The Authority has continued to submit information required in order to be eligible for the Certainty Rate and be on the PWLB approved list of Authorities who could access the preferential rates. Thus any future borrowing can be done at this preferential rate.

12.0 Investment Activity

12.1 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.

12.2 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.

12.3 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.

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

12.5 As at the 31 March 2017, all short term investments have given a return to the Authority of £223,456 in 2016/17 as shown in Table 6 below, and an average rate of 0.56%.

Table 6: Investment Interest

Period April 16 - March 17	Average Rate	Investment Interest Earned £
National Counties Building Society	0.80%	19,375
Newcastle Building Society	0.80%	19,375
West Bromwich Building Society	0.78%	18,891
Lloyds Bank Plc	0.75%	31,507
Santander UK plc (call)	0.66%	71,533
Close Brothers	0.50%	1,027
Lloyds Bank Plc (call)	0.46%	27,802
London Borough of Haringey	0.45%	25
Nottingham Building Society	0.43%	2,827
Police & Crime Commissioner	0.35%	67
Telford & Wrekin	0.30%	1,151
HSBC Global Liquidity Fund	0.25%	24,240
Barclays Bank (call)	0.25%	1,496
HSBC Bank Plc (call)	0.12%	4,140
TOTAL INVESTMENT INTEREST		**223,456**

12.6 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 23 August 2016. Investments held as at the 31 March 2017 were as set in Table 7 below:

Table 7 - Short Term Investments held as at 31 March 2017

	Interest Rate %	Investment Value £000	Investment type	Maturity date
London Borough of Haringey	0.45	2,000	Fixed	28/04/2017
National Counties Building Society	0.80	4,000	Fixed	22/08/2017
Newcastle Building Society	0.80	4,000	Fixed	22/08/2017
West Bromwich Building Society	0.78	4,000	Fixed	22/08/2017
Close Brothers	0.50	5,000	Fixed	15/09/2017
Lloyds Fixed Term	1.00	5,000	Fixed	29/09/2017
Santander	0.55	10,000	Call	
Lloyds Bank Plc	0.37	5,000	Call	
HSBC Bank Plc (MMF)	0.25	11,200	Call	
Total		**50,200**		

12.7 For information, the investment with HSBC Global Liquidity Fund of £11.2m 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.

13.0 Interest Rates

13.1 At the start of 2016/17 the base rate stood at 0.50%. On 4 August 2016, however and following the unexpected result of the EU referendum, the Bank of England base rate was reduced from 0.50% to 0.25%; the first change to the rate since 2009.

13.2 This change was against the expectation some months previous of an increase in rates towards the latter part of 2016. The Authority's treasury adviser Arlingclose's central case currently is for UK Bank Rate to remain at 0.25% during 2017 / 18.

13.3 The Bank of England has, however, highlighted that excessive levels of inflation will not be tolerated for sustained periods. Given this view and the current inflation outlook, further falls in the Bank Rate look less likely.

13.4 Negative Bank Rates, although a low probability, cannot be entirely ruled out in the medium term, particularly if the UK enters recession as a result of concerns over leaving the European Union.

14.0 Performance measurement

14.1 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.

14.2 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 31 March 2017 are shown in Appendix 1. All key prudential indicators are met or complied with.

15.0 Treasury Management Strategy

15.1 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."*

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

15.3 It should be noted that for a short period during 2016/17, the Treasury Management Group endorsed the placement of funds with Santander Plc at a level which exceeded the Treasury Management Strategy guidelines. This resulted in a short term deposit of £15m being held on call with Santander versus the Treasury Management Strategy suggested cap of £10m per financial institution. The decision was taken by the Group following an assessment of the likely risks whilst the WMCA counter-party list was being broadened. Once the WMCA counter-party list was broadened, the investment with Santander was returned to the recommended level.

16.0 Counterparty Ratings

16.1 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.

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

16.3 At the end of November, the Bank of England released the results of its latest stress tests on the seven largest UK banks and building societies (Barclays, HSBC, Lloyds/Bank of Scotland, Santander UK, HSBC, RBS/Natwest and Nationwide BS). The 2016 stress tests were more challenging and designed under a new Bank of England framework, which tested the resilience of banks to tail risk events. Royal Bank of Scotland, Barclays and Standard Chartered Bank were found to be the weakest performers.

16.4 The stress tests were based on banks' financials as at 31 December 2015; one of the main short-comings of these tests is that by the time the results are published, they are 11 months out of date for most banks. As part of its creditworthiness research and advice, the Authority's treasury advisor Arlingclose regularly undertakes analysis of relevant ratios - "total loss absorbing capacity" (TLAC) or "minimum requirement for eligible liabilities" (MREL) - to determine whether there would be a bail-in of senior investors, such as local authority deposits, in a stressed scenario.

16.5 Changes to long-term credit ratings over the quarter included Moody's upgrades to rating of both Barclays Bank and Credit Suisse to A1 and to Santander UK plc's rating to Aa3 from A1. S&P upgraded the long-term rating of Goldman Sachs International Bank to A+ from A.

16.6 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.

16.7 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.

17.0 Prudential Code and Indicators

17.1 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

17.2 The Authority's Prudential Indicators for 2016/17 were set out as part of the Treasury Management Strategy, shown in appendix 1. These show that the authority is compliant with Prudential Code and parameters set at the beginning of the year.

APPENDIX 1 : Summary Prudential Indicators

Measure	2016/17 Outturn £000	2016/17 Forecast £000	NOTES
Affordability			
Ratio of financing costs to net revenue stream:			
(a) financing costs	14,137	14,814	Finance costs are reduced due to effective cash flow management reducing the need to borrow
(b) net revenue stream	161,330	152,330	A full year of devoloution deal funding was received vs the expected pro-rate amount in the 16/17 Forecast
Percentage	8.76%	9.72%	
Estimates of Capital Investment on Income (%)	(1.56%)	(1.20%)	The percentage difference reflects the lower borrowing and incresed income position
Prudence			
Gross borrowing and the capital financing requirement:			
Gross Borrowing (excludes inhereted debt)	**157,719**	**175,081**	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)	192,438	196,937	
Capital Expenditure, External Debt and Treasury Management			
Capital Expenditure	37,874	173,442	The reduction in capital spend is largely due to a deferal of Devoloution Deal Investment Programme spend into later years and borroring undertaken in relation the to Collective Investment Vehicle being undertaken by Birmingham until suitable powers are acquired by WMCA.
Operational boundary for external debt			
Operational boundary for borrowing	235,719	253,081	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	240,719	258,081	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%	
Upper limit on variable rate exposures	30%	30%	
Investments longer than 364 days			
Upper limit	8,000	8,000	

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