Audit, Risk & Assurance Committee

Date	8 September 2020
Report title	Treasury Management Strategy
Accountable Chief Executive	Deborah Cadman, OBE Chief Executive Email: Deborah.Cadman@wmca.org.uk Tel: (0121) 214 7200
Accountable Employee	Carl Pearson, Head of Financial Planning Email: Carl.Pearson@wmca.org.uk Tel: (0121) 214 7222
Report has been considered by	Not Applicable

Recommendation(s) for action or decision:

The Audit, Risk & Assurance Committee is recommended to:

(1) Note the Treasury Management Strategy included in Appendix 1 which is provided for background information in preparation for a short presentation at the meeting.

1. Purpose

1.1 WMCA as a public body are required to have regard to the Chartered Institute of Public Finance and Accountancy (CIPFA) code of practice in discharging all its financial responsibilities.

1.2 In relation to Treasury Management, The Code states that the organisation delegates responsibility for the implementation and regular monitoring of its Treasury Management Policies to Audit, Risk & Assurance Committee (as an independent scrutiny function). Officers are subsequently obliged to operate within the Treasury Management Strategy parameters as set and monitored by the scrutiny function.

1.3 ARAC members received an overview on WMCAs Treasury Management practices in February 2020 and it was agreed that a subsequent session would be arranged to review the Treasury Management Strategy for the year.

1.4 The meeting of ARAC on 8 September 2020, will receive a short presentation on the Treasury Management Strategy for 2020/21. The presentation will highlight key areas of focus for members in their consideration of the Treasury Management Strategy including associated information, methodology calculation and measurements in regard to assurance to be sought.

1.5 To assist with this session, the 2020/21 Treasury Management Strategy is appended to this report for background information only.

APPENDIX 1

Treasury Management Strategy Statement 2020/21

Introduction

Treasury management is the management of WMCA's cash flows, borrowing and investments, and the associated risks. WMCA has invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of financial risk are therefore central to WMCA's prudent financial management.

Treasury risk management at WMCA is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2017 Edition* (the CIPFA Code) which requires WMCA to approve a treasury management strategy before the start of each financial year. This report fulfils WMCA's legal obligation under the *Local Government Act 2003* to have regard to the CIPFA Code.

External Context

The UK's progress negotiating its exit from the European Union, together with its future trading arrangements, will continue to be a major influence on the Authority's treasury management strategy for 2020/21.

The Bank of England maintained Bank Rate to 0.75% in November. Despite keeping rates on hold, Monetary Policy Committee members did confirm that if Brexit uncertainty continues or global growth fails to recover, they are prepared to cut interest rates as required.

Credit conditions for larger UK banks have remained stable over the past year and whilst there remains some concern over a global economic slowdown, this has yet to manifest in any credit issues for banks. Meanwhile, the post financial crisis banking reform is now largely complete, with the new ringfenced banks embedded in the market.

Challenger banks hit the news headlines in 2019 with Metro Bank and TSB Bank both suffering adverse publicity and falling customer numbers.

Looking forward, the potential for a "no-deal" Brexit and/or a global recession remain the major risks facing banks and building societies in 2020/21 and a cautious approach to bank deposits remains advisable.

The Authority's treasury management adviser Arlingclose is forecasting that Bank Rate will remain at 0.75% until the end of 2022. The risks to this forecast are deemed to be significantly weighted to the downside, particularly given the continuing global economic slowdown.

Gilt yields have risen but remain at low levels and only some very modest upward movement from current levels are expected based on Arlingclose's interest rate projections. The central case is for 10-year and 20-year gilt yields to rise to around 1.00% and 1.40% respectively over the time horizon.

Local Context

The need to manage cash effectively and make robust borrowing decisions will be largely driven by the delivery of the WMCA Capital Programme which contains the WMCA Investment Programme. The WMCA elements of the Investment Programme are largely funded through borrowing and as a number of both WMCA and Local Authority schemes enter the delivery phase, the draw on WMCA resources is expected to be significant. Further details regarding the financing of the Capital Programme is included in the WMCA Capital Strategy which features as Appendix 8.

On 31 December 2019, WMCA held £131.1m of borrowing and £108.5m of investments.

The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. WMCA's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

WMCA has an increasing CFR due to the capital programme, but lower values of investments will therefore require WMCA to borrow up to £777m (net of investment income) over the forecast period, mostly driven by the delivery of the WMCA Investment Programme as detailed above.

Table 1: WMCA Capital Financing Requirement

Gross External Debt vs CFR (£M)	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
Opening External Debt	136.3	150.3	455.3	793.3	893.3	903.3
New Borrowing *	14.0	305.0	338.0	100.0	10.0	10.0
Forecast Closing External Debt	**150.3**	**455.3**	**793.3**	**893.3**	**903.3**	**913.3**
Capital Financing Requirement	377.8	673.8	923.3	1,070.1	1,087.8	1,058.9
Under Borrowing	227.6	218.5	130.0	176.9	184.5	145.6

* After effective use of available resources

CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that WMCA's total debt should be lower than its highest forecast CFR over the next three years. Table 2 shows that WMCA expects to comply with this recommendation during 2020/21.

HM Treasury External Debt Cap

WMCA has acquired approval from HM Treasury and MHCLG to borrow for all of its functions subject to it operating within an agreed external debt cap which was agreed during February 2018. The debt cap runs coterminous with the 5 year gateway review period and the caps for 2021/22 and beyond are expected to be discussed with HM Treasury during 2020/21.

WMCA do not expect to breach the debt cap during 2020/21 based on the current external debt and projections for the 2020/21 financial year. For information, the debt limit agreed for 2020/21 is £1,042 million.

Borrowing Strategy

As at 31 December 2019 WMCA currently holds £131.1m of loans, a decrease of £6.0m on the previous year. The forecast in table 1 shows that WMCA expects to borrow up to £305m in 2020/21. WMCA may also borrow additional sums to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing.

Objectives: WMCA's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving certainty of those costs over the period for which funds are required. The flexibility to renegotiate loans should WMCA's long-term plans change is a secondary objective.

Strategy: WMCA's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead.

By doing so, WMCA is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of short-term borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. Arlingclose will assist WMCA with this 'cost of carry' and breakeven analysis. Its output may determine whether WMCA borrows additional sums at long-term fixed rates in 2020/21 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

WMCA has previously raised the majority of its long-term borrowing from the PWLB but the government increased PWLB rates by 1% in October 2019 making it a relatively expensive option. WMCA will now look to borrow any long-term loans from other sources including banks, pensions and local authorities, and will investigate the possibility of issuing bonds and similar instruments, in order to lower interest costs and reduce over-reliance on one source of funding in line with the CIPFA Code. WMCA Finance Directors continue to work collectively also, to ensure the buying power of the region is fully exploited in the capital markets.

It should be noted that following a competitive process, during 2019/20, WMCA were notified by HM Treasury that it would qualify for Infrastructure Rate Funding. This effectively guarantees WMCA access to £100m of debt at 1.2% below the currently published levels. Access to this financing together with the use of short term debt will provide WMCA with a bridge whilst other more competitive sources of long term finance are identified.

Additionally, WMCA will look to identify suitable forward starting loans, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period.

In addition, WMCA may borrow using further short-term loans to cover unplanned cash flow shortages.

Sources of borrowing: The approved sources of long-term and short-term borrowing are:

- Public Works Loan Board (PWLB) and any successor body
- any institution approved for investments (see below)
- any other bank or building society authorised to operate in the UK
- any other UK public sector body
- UK public and private sector pension funds (except West Midlands Local Government Pension Fund)
- capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

Other sources of debt finance: In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

- leasing
- hire purchase
- Private Finance Initiative
- sale and leaseback

Municipal Bonds Agency: UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. It plans to issue bonds on the capital markets and lend the proceeds to local authorities. This will be a more complicated source of finance than the PWLB for two reasons: borrowing authorities will be required to provide bond investors with a guarantee to refund their investment in the event that the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will therefore be the subject of a separate report to WMCA Board.

Short-term and variable rate loans: These loans leave WMCA exposed to the risk of short-term interest rate rises and are therefore subject to the interest rate exposure limits in the treasury management indicators below.

Debt rescheduling: The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms. WMCA may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk.

Investment Strategy

WMCA holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, WMCA's investment balance has ranged between £38.7m and £231.5m, and similar levels are expected to be maintained throughout parts of 2020/21 largely due to the profile of Government grant receipts in quarter one.

Objectives: The CIPFA Code requires WMCA to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. WMCA's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably

low investment income. Where balances are expected to be invested for more than one year, WMCA will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.

Negative interest rates: If the UK enters into a recession in 2020/21, there is a small chance that the Bank of England could set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

Strategy: Given the increasing risk and very low returns from short-term unsecured bank investments, WMCA aims to further diversify into more secure and/or higher yielding asset classes during 2020/21. This is especially the case for the estimated £10m that is available for longer-term investment to ensure MiFID compliance. A significant amount of WMCA's surplus cash is currently invested in short-term unsecured bank deposits, and money market funds. This diversification will represent a continued change in strategy over the coming year.

Business models: Under the new IFRS 9 standard, the accounting for certain investments depends on WMCA's "business model" for managing them. WMCA aims to achieve value from its internally managed treasury investments by a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.

Approved counterparties: WMCA may invest its surplus funds with any of the counterparty types in table 3 below, subject to the cash limits (per counterparty) and the time limits shown.

Table 3: Approved investment counterparties and limits

<table>
<tr><th rowspan="2">Credit Rating of Institution or Product</th><th colspan="2">UK Banks and Financial Institutions</th><th rowspan="2">UK Government</th><th rowspan="2">Corporates</th></tr>
<tr><th>Unsecured</th><th>Secured</th></tr>
<tr><td>AAA</td><td rowspan="7">£20m Per Counter Party
(1 Year Max)*</td><td rowspan="7">£20m Per Counter Party
(3 Years Max)*</td><td rowspan="10">£ Unlimited 50 Yrs Max</td><td>£10m (2Yrs) Max</td></tr>
<tr><td>AA+</td><td rowspan="2">£5m (1 Yr) Max</td></tr>
<tr><td>AA</td></tr>
<tr><td>AA-</td><td rowspan="4">£1m (1 Yr) Max</td></tr>
<tr><td>A+</td></tr>
<tr><td>A</td></tr>
<tr><td>A-</td></tr>
<tr><td>BBB+</td><td>£4m (100 days)</td><td>£5m (2 Yrs Max)</td><td rowspan="3">No Investments to be placed</td></tr>
<tr><td>BBB or BBB-</td><td colspan="2">£1m (Call Only)</td></tr>
<tr><td>None/Un-rated</td><td colspan="2">£1m (6mths)</td></tr>
<tr><td colspan="5"></td></tr>
<tr><td colspan="5"></td></tr>
<tr><td colspan="5"></td></tr>
<tr><td colspan="5"></td></tr>
<tr><td colspan="5"></td></tr>
<tr><td colspan="5"></td></tr>
<tr><td colspan="5"></td></tr>
<tr><td colspan="5"></td></tr>
<tr><td colspan="5"></td></tr>
<tr><th colspan="5">Pooled Funds / Money Market Funds</th></tr>
<tr><td colspan="2">Constant Net Asset Value</td><td>AA+</td><td colspan="2">£20m per Fund</td></tr>
<tr><td colspan="2">Low-Volatility Net Asset Value</td><td>AAA</td><td colspan="2">£20m per Fund</td></tr>
<tr><td colspan="2">Variable Net Asset Value</td><td>AAA</td><td colspan="2">£5m per Fund</td></tr>
<tr><th colspan="3">UK Non Domiciled Bank</th><th>Unsecured</th><th>Secured</th></tr>
<tr><td colspan="3">Non-UK Banks must be domiciled in a country which has a minimum sovereign Long Term rating of 'AA-'</td><td>£20m Per Counter Party (1 Year Max)**</td><td>£20m Per Counter Party (3 Years Max)</td></tr>
</table>

* Normal operating levels will not exceed £10m but adequate headroom has been provided to accommodate potential peek cash-flow requirements. The Combined Authority will look to keep an even spread of investments across counter parties to minimise exposure to defaults.

This table must be read in conjunction with the notes overleaf.

Credit rating: Investment limits are set by reference to the lowest published long-term credit rating from a selection of external rating agencies. Where available, the credit rating relevant to

the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be taken into account.

Banks unsecured: Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. See below for arrangements relating to operational bank accounts.

Banks secured: Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the higher of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits. The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

Government: Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

Corporates: Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent.

Pooled funds: Shares or units in diversified investment vehicles consisting of the any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee.

Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow WMCA to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting WMCA's investment objectives will be monitored regularly.

Operational bank accounts: WMCA may incur operational exposures, for example though current accounts, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments, but are still subject to the risk of a bank bail-in, and balances will therefore be kept below £1m per bank. The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of WMCA maintaining operational continuity.

Risk assessment and credit ratings: Credit ratings are obtained and monitored by WMCA's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

- no new investments will be made,
- any existing investments that can be recalled or sold at no cost will be, and
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as "rating watch negative" or "credit watch negative") so that it may fall below the approved rating criteria, then only investments that can be withdrawn will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

Other information on the security of investments: WMCA understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may otherwise meet the above criteria.

When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, WMCA will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security.

Investment limits: In order that WMCA's reserves will not be put at significant risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £20 million. A group of banks under the same ownership will be treated as a single organisation for limit purposes. Limits will also be placed on fund managers, investments in brokers' nominee accounts, foreign countries and industry sectors as below.

Table 4: Investment limits

	Cash limit
UK Central Government	unlimited
Any group of organisations under the same ownership	£20m per group
Any group of pooled funds under the same management	£20m per manager
Negotiable instruments held in a broker's nominee account	£20m per broker
Foreign countries	£5m per country
Unsecured investments with building societies	£10m in total
Loans to unrated commercial entities	See Below
Money market funds (Sector Limit)	£80m in total
UK Banks and Building Societies (Sector Limit)	£80m in total
Unrated Banks / Building Societies (Sector Limit)	£5m in total

Liquidity management: WMCA employ Treasury specialists to build cash flow forecasts to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis to minimise the risk of WMCA being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to WMCA's medium-term financial plan and cash flow forecast.

Commercial Investment Funds

WMCA operate commercial loan funds on behalf of the Constituent Local Authorities. The investment funds have recently been increased from £70m to £210m and provide loans at a commercial rate to developers where the more traditional financial institutions are not willing to lend on agreeable terms.

The primary objective of the investment funds is to stimulate economic regeneration and to date, the fund has committed £109.4m of which £24.5m has been repaid and £23.3m is currently drawn.

Whilst these developers do not have a credit rating in the traditional sense, WMCA employ fund manager's West Midlands Development Capital to ensure adequate due diligence is undertaken and each loan agreement will be adequately secured, usually on the land / buildings underpinning the requirement. Furthermore, each loan agreement requires approval by Investment Board and protections around concentration risk (i.e. limiting the cumulative value of loans to any one developer) were reviewed and approved by WMCA Investment Board in July 2019.

Treasury Management Indicators

WMCA measures and manages its exposures to treasury management risks using the following indicators.

Security: WMCA has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

Credit risk indicator	**Target**
Portfolio average credit	*A minus*

Liquidity: WMCA has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing.

Liquidity risk indicator	**Target**
Total cash available within 3 months	£50m (Min)

Maturity structure of borrowing: This indicator is set to control WMCA's exposure to refinancing risk. The upper and lower limits on the maturity structure of borrowing will be:

Refinancing rate risk indicator	Upper limit	Lower limit
Under 12 months	15%	0%
12 months and within 24 months	20%	0%
24 months and within 5 years	20%	0%
5 years and within 10 years	20%	0%
10 years and above	25%	25%

Principal sums invested for periods longer than a year: The purpose of this indicator is to control WMCA's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end will be:

Price risk indicator	2020/21	2021/22	2022/23
Limit on principal invested longer than a year	£10m	£10m	£10m

Related Matters

The CIPFA Code requires WMCA to include the following in its treasury management strategy.

Financial Derivatives: Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). The general power of competence in Section 1 of the *Localism Act 2011* removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

WMCA will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that WMCA is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds and forward starting transactions, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

In line with the CIPFA Code, WMCA will seek external advice and will consider that advice before entering into financial derivatives to ensure that it fully understands the implications.

Financial Derivatives: In the absence of any explicit legal power to do so, WMCA will not use standalone financial derivatives (such as swaps, forwards, futures and options). Derivatives embedded into loans and investments, including pooled funds and forward starting transactions, may be used, and the risks that they present will be managed in line with the overall treasury risk management strategy.

Markets in Financial Instruments Directive: WMCA has retained retail client status with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of WMCA's treasury management activities, the Section 151 Officer considers this to be the most appropriate status.

Treasury Management Strategy: Annex 1

	31 Dec 19 Actual £m	Average Rate %
External borrowing:		
Public Works Loan Board	113.92	5.18
Loans from banks	10.00	4.03
Total external borrowing	123.92	
Other long-term liabilities:		
Transferred Debt	7.18	6.70
Total other long-term liabilities	7.18	
Total gross external debt	**131.10**	
Treasury investments:		
Banks & building societies (unsecured)	11.00	0.65
Government (incl. local authorities)	75.00	0.72
Money Market Funds	17.00	0.70
Overnight Deposits	5.55	0.45
Total treasury investments	**108.55**	
Net debt	22.55	