

**REPORT TO: WEST OF ENGLAND MAYORAL COMBINED
AUTHORITY AUDIT COMMITTEE**

DATE: 11th DECEMBER 2023

**REPORT TITLE: TREASURY MANAGEMENT STRATEGY
STATEMENT 2024/25 INCLUDING TREASURY
MANAGEMENT 2023/24 MONITORING UPDATE**

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Purpose of Report

The Chartered Institute of Public Finance and Accountancy's, (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. The 2024/25 Strategy will be submitted to the January 2024 West of England Mayoral Combined Authority Committee for approval alongside the 2024/25 budget papers.

Recommendations

The West of England Mayoral Combined Authority Audit Committee is required to:

- (a) Note the Treasury Management Strategy for 2024/25 and recommend any amendments prior to it being submitted to the January 2024 West of England Mayoral Combined Authority Committee for approval;
- (b) Note the Treasury Management Monitoring update to 31st October 2023, prepared in accordance with the CIPFA Treasury Code of Practice and the Treasury Management Indicators.

1. Introduction

- 1.1 Treasury management is the management of the Authority's cash flows, borrowing and investments, and the associated risks. The Authority has substantial sums of money invested 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 the Authority's prudent financial management.
- 1.2 Treasury risk management at the Authority is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2021 Edition* (the CIPFA Code) which requires the Authority to approve a Treasury Management Strategy before the start of each financial year. This report fulfils the Authority's legal obligation under the *Local Government Act 2003* to have regard to the CIPFA Code.

2. External Context

- 2.1 **Economic background:** The impact on the UK from higher interest rates and inflation, a weakening economic outlook, an uncertain political climate due to an upcoming general election, together with war in Ukraine and the Middle East, will be major influences on the Authority's treasury management strategy for 2024/25.
- 2.2 The Bank of England (BoE) increased Bank Rate to 5.25% in August 2023, before maintaining this level in September and then again in November. Members of the BoE's Monetary Policy Committee voted 6-3 in favour of keeping Bank Rate at 5.25%. The three dissenters wanted to increase rates by another 0.25%.
- 2.3 The November quarterly Monetary Policy Report (MPR) forecast a prolonged period of weak Gross Domestic Product (GDP) growth with the potential for a mild contraction due to ongoing weak economic activity. The outlook for CPI inflation was deemed to be highly uncertain, with near-term risks to CPI falling to the 2% target coming from potential energy price increases, strong domestic wage growth and persistence in price-setting
- 2.4 Office for National Statistics figures showed the UK economy grew by 0.2% between April and June 2022. The BoE forecasts GDP will likely stagnate in Q3 but increase modestly by 0.1% in Q4, a deterioration in the outlook compared to the August MPR. The BoE forecasts that higher interest rates will constrain GDP growth, which will remain weak over the entire forecast horizon.

- 2.5 Office for National Statistics (ONS) figures showed CPI inflation was 6.7% in September 2023, unchanged from the previous month but above the 6.6% expected. Core CPI inflation fell to 6.1% from 6.2%, in line with predictions. Looking ahead, using the interest rate path implied by financial markets the BoE expects CPI inflation to continue falling, declining to around 4% by the end of calendar 2023 but taking until early 2025 to reach the 2% target and then falling below target during the second half 2025 and into 2026.
- 2.6 The labour market appears to be loosening, but only very slowly. The unemployment rate rose slightly to 4.2% between June and August 2023, from 4.0% in the previous 3-month period, but the lack of consistency in the data between the two periods made comparisons difficult. Earnings growth remained strong, with regular pay (excluding bonuses) up 7.8% over the period and total pay (including bonuses) up 8.1%. Adjusted for inflation, regular pay was 1.1% and total pay 1.3%. Looking forward, the MPR showed the unemployment rate is expected to be around 4.25% in the second half of calendar 2023, but then rising steadily over the forecast horizon to around 5% in late 2025/early 2026.
- 2.7 Having increased its key interest rate to a target range of 5.25-5.50% in August 2023, the US Federal Reserve paused in September and November, maintaining the Fed Funds rate target at this level. It is likely this level represents the peak in US rates, but central bank policymakers emphasised that any additional tightening would be dependent on the cumulative impact of rate rises to date, together with inflation and developments in the economy and financial markets
- 2.8 US GDP grew at an annualised rate of 4.9% between July and September 2023, ahead of expectations for a 4.3% expansion and the 2.1% reading for Q2. But as the impact from higher rates is felt in the coming months, a weakening of economic activity is likely. Annual CPI inflation remained at 3.7% in September after increasing from 3% and 3.2% consecutively in June and July.
- 2.9 Eurozone inflation has declined steadily since the start of 2023, falling to an annual rate of 2.9% in October 2023. Economic growth has been weak, and GDP was shown to have contracted by 0.1% in the three months to September 2023. In line with other central banks, the European Central Bank has been increasing rates, taking its deposit facility, fixed rate tender, and marginal lending rates to 3.75%, 4.25% and 4.50% respectively.
- 2.10 **Credit outlook:** Credit default swap (CDS) prices were volatile during 2023, spiking in March on the back of banking sector contagion concerns following the major events of Silicon Valley Bank becoming insolvent and the takeover of Credit Suisse by UBS. After then falling back in Q2 of calendar 2023, in the

second half of the year, higher interest rates and inflation, the ongoing war in Ukraine, and now the Middle East, have led to CDS prices increasing steadily.

- 2.11 On an annual basis, CDS price volatility has so far been lower in 2023 compared to 2022, but this year has seen more of a divergence in prices between ringfenced (retail) and non-ringfenced (investment) banking entities once again.
- 2.12 Moody's revised its outlook on the UK sovereign to stable from negative to reflect its view of restored political predictability following the volatility after the 2022 mini-budget. Moody's also affirmed the Aa3 rating in recognition of the UK's economic resilience and strong institutional framework. Following its rating action on the UK sovereign, Moody's revised the outlook on five UK banks to stable from negative and then followed this by the same action on five rated local authorities. However, within the same update the long-term ratings of those five local authorities were downgraded.
- 2.13 There remain competing tensions in the banking sector, on one side from higher interest rates boosting net income and profitability against another of a weakening economic outlook and likely recessions that increase the possibility of a deterioration in the quality of banks' assets. However, the institutions on our adviser Arlingclose's counterparty list remain well-capitalised and their counterparty advice on both recommended institutions and maximum duration remain under constant review and will continue to reflect economic conditions and the credit outlook.
- 2.14 **Interest rate forecast (November 2023):** Although UK inflation and wage growth remain elevated, the Authority's treasury management adviser Arlingclose forecasts that Bank Rate has peaked at 5.25%. The Bank of England's Monetary Policy Committee will cut rates in the medium term to stimulate the UK economy but will be reluctant to do so until it is sure there will be no lingering second-round effects. Arlingclose sees rate cuts from Q3 2024 to a low of around 3% by early-mid 2026. A more detailed economic and interest rate forecast provided by Arlingclose is in **Appendix A**.
- 2.15 Arlingclose expects long-term gilt yields to eventually fall from current levels (amid continued volatility) reflecting the lower medium-term path for Bank Rate. However, yields will remain relatively higher than in the past, due to quantitative tightening and significant bond supply. As ever, there will undoubtedly be short-term volatility due to economic and political uncertainty and events.
- 2.16 Like the BoE, the Federal Reserve and other central banks see persistently high policy rates through 2023 and 2024 as key to dampening domestic inflationary pressure. Bond markets will need to absorb significant new supply, particularly from the US government.

- 2.17 For the purpose of setting the budget, it has been assumed that new investments will be made at an average rate of 4% for the West of England Mayoral Combined Authority balances, and 3% for Revolving Infrastructure Fund (RIF) balances. Lower levels of interest received on LEP balances due to longer term investments of funds being limited. Higher rates can only be achieved through retaining a proportion of our portfolio as long terms investments such as property, equities and mixed asset funds.

3. Local Context

- 3.1 On 31st October 2023, the Authority held £403m of investments, and £5m in short term borrowing. This is set out in further detail at **Appendix B**.
- 3.2 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.
- 3.3 The Authority's capital expenditure plans do not currently imply any need to borrow over the forecast period. Investments are forecast to fall to £300m by the end of 2024/25 as capital grants are used to finance capital expenditure and earmarked reserves are spent on their intended purpose.

4. Investment Strategy

- 4.1 The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. Since 1st April 2023, the Authority's investment balance has ranged between £335m and £403m, and similar levels are expected to be maintained in the forthcoming year.
- 4.2 As well as holding investments in its own right, the Authority also acts as Accountable Body for the West of England Revolving Investment Fund (RIF) and Local Enterprise Partnership (LEP) holding Government Grants until they are ready to be distributed to Local Authorities and other organisations for approved project spend over the coming years.
- 4.3 The funds are invested primarily to protect the capital and, to achieve a high level of capital security, investments are made predominantly with Central Government, Local Authorities and Banks with high credit ratings. See **Appendix C** for Treasury Monitoring.
- 4.4 Interest earned on Revolving Infrastructure Fund and Local Enterprise Partnership Investments are re-invested into their Funds.
- 4.5 **Objectives:** The Chartered Institute of Public Finance and Accountancy Code requires the Authority 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. The Authority’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, the Authority 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. Given the current October level of CPI at 4.7% this will be difficult to achieve with fixed term deposits alone. However, we will continue to consider further longer-term investments within our overall investment portfolio, such as pooled funds, which may achieve a higher rate of return. Any temporary liquidity issues that may arise throughout the year will be dealt with by short term borrowing. The Authority aims to be a responsible investor and will consider environmental, social and governance (ESG) issues when investing.

- 4.6 **Strategy:** The Authority expects to be a long-term investor and treasury investments will therefore include both short-term low risk instruments to manage day-to-day cash flows and longer-term instruments where limited additional risk is accepted in return for higher investment income. The Authority aims to further diversify into more secure and/or higher yielding asset classes during 2024/25. A reduced proportion of the Authority’s surplus cash remains invested in short-term unsecured bank deposits and money market funds. This diversification will represent a continuation of the strategy adopted in 2023/24 with outer limits set for treasury management operations.
- 4.7 **Business models:** Under the International Financial Reporting Standard 9, the accounting for certain investments depends on the Authority’s “business model” for managing them. The Authority 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.
- 4.8 **Approved counterparties:** The Authority may invest its surplus funds with any of the counterparty types as detailed in *Figure 1*, subject to the cash limits (per counterparty), and the time limits shown.

Figure 1: Approved investment counterparties and limits

Sector	Time limit	Counterparty limit	Sector limit
The UK Government	50 years	Unlimited	n/a
Local authorities & other government entities	25 years	£10m	Unlimited

Secured investments *	25 years	£15m	Unlimited
Banks (unsecured) *	13 months	£10m	Unlimited
Building societies (unsecured) *	13 months	£10m	£20m
Registered providers (unsecured) *	5 years	£10m	£50m
Money market funds *	n/a	£10m	Unlimited
Strategic pooled funds	n/a	£10m	£60m
Real estate investment trusts	n/a	£10m	£50m
Other investments *	5 years	£10m	£20m

This table must be read in conjunction with the following notes:

- a) **Minimum Credit rating:** Treasury investments in the sectors marked with an asterisk will only be made with entities whose lowest published long-term credit rating is **no lower than A-**. 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 considered.

For entities without published credit ratings, investments may be made either:

- (i) where external advice indicates the entity to be of similar credit quality; or
- (ii) to a maximum of £10m per counterparty as part of a diversified pool e.g. via a peer-to-peer platform.

- b) **Banks and building societies 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.
- c) **Secured investments:** Investments secured on the borrower's assets, which limits the potential losses in the event of insolvency. The amount and quality of the security will be a key factor in the investment decision. 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.

- d) **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.
- e) **Registered providers (unsecured):** Loans and bonds issued by, guaranteed by or secured on the assets of registered providers of social housing and registered social landlords, formerly known as housing associations. These bodies are tightly regulated by the Regulator of Social Housing (in England), the Scottish Housing Regulator, the Welsh Government and the Department for Communities (in Northern Ireland). As providers of public services, they retain the likelihood of receiving government support if needed.
- f) **Money Market Funds:** Pooled funds that offer same-day or short notice liquidity and very low or no price volatility by investing in short-term money markets. They have the advantage over bank accounts of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a small fee. Although no sector limit applies to money market funds, the Authority will take care to diversify its liquid investments over a variety of providers to ensure access to cash at all times.
- g) **Strategic Pooled funds:** Shares or units in diversified investment vehicles consisting of 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. Short-term Money Market Funds that offer same-day liquidity and very low or no volatility will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Authority 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 the Authority's investment objectives will be monitored regularly.

- h) **Real estate investment trusts:** Shares in companies that invest mainly in real estate and pay the majority of their rental income to investors in a similar manner to pooled property funds. As with property funds, REITs offer enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties.
- i) **Other investments:** This category covers treasury investments not listed above, for example unsecured corporate bonds and company loans. Non-bank companies cannot be bailed-in but can become insolvent placing the Authority's investment at risk.
- j) **Operational bank accounts:** The Authority may incur operational exposures, for example through current accounts, collection accounts and merchant acquiring services, 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 £500,000 per bank. This is a relatively low risk as deposits tend to be only held overnight and can be moved without notice. 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 the Authority maintaining operational continuity.
- k) **Risk assessment and credit ratings:** Credit ratings are obtained and monitored by the Authority's treasury advisers, ArlingClose, 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 on the next working day 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.

- l) **Other information on the security of investments:** The Authority 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, including credit default swap prices, financial statements, information on potential government support, reports in the quality financial press and analysis and advice from the Authority's treasury management adviser. 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.

The Authority is aware that investment with certain counterparties, while considered secure from a purely financial perspective, may leave it open to criticism, valid or otherwise, that may affect its public reputation, and this risk will therefore be taken into account when making investment decisions.

When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008, 2020 and 2022, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Authority 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. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Authority's cash balances, then the surplus will either be deposited with the UK Government, (via the Debt Management Office), invested in government treasury bills or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

- m) **Environmental, Social & Governance (ESG) Investments:** Environmental, social and governance (ESG) considerations are increasingly a factor in global investors' decision making, but the framework for evaluating investment opportunities is still developing and therefore the Authority does not currently include ESG scoring or other real-time ESG criteria at an individual investment level. When investing in banks and funds, the Authority will prioritise banks that are signatories to the UN Principles for Responsible Banking and funds operated by managers that are signatories to the UN Principles for Responsible Investment, the Net Zero Asset Managers Alliance and/or the UK Stewardship Code. The Authority recognises it can further enhance its efforts through its investment decisions and activity. The Authority will consider options for investments of short-term funds with institutions who ring fence the use of such funds for ESG related matters. The Authority will continue to use the Arlingclose ESG and Responsible Investment Service, designed to guide and advise authorities on incorporating and monitoring ESG in its treasury investment decisions.

- n) **UA Short Term Loan Facility:** In order to assist the West of England Unitary Authorities who may continue to face cashflow challenges, the Authority has implemented a short-term loan facility and this will be operated within the parameters of the approved Treasury Management Strategy.
- o) **Investment limits:** The maximum that will be lent to any one organisation, (other than the UK Government), will be £10 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. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country, since the risk is diversified over many countries. The Authority's revenue reserves, which could be made available to cover any investment losses, are forecast to be £4 million on 31st March 2024. There is also a £1.6m Treasury Management Earmarked Reserve available.

Figure 2: Investment Limits

	Cash limit
Any single organisation, except the UK Central Government	£10m each
UK Central Government	unlimited
Any group of organisations under the same ownership	£10m per group
Any group of pooled funds under the same management	£10m per manager
Negotiable instruments held in a broker's nominee account	£10m per broker
Foreign countries	£15m per country (AAA sovereign rating)
	£10m per country (AA+ sovereign rating)
Registered providers and registered social landlords	£50m in total
Unsecured investments with building societies	£20m in total
Loans to unrated corporates	£20m in total
Money market funds	unlimited
Real estate investment trusts	£50m in total

Liquidity management: The Authority uses cash flow forecasting 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 the Authority being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Authority's medium-term financial plan and cash flow forecast. The Authority will spread its liquid cash over at least five providers (e.g. bank accounts and money market funds) to ensure that access to cash is maintained in the event of operational difficulties at any one provider.

5. Borrowing Strategy

5.1 The Authority currently holds £5m of short-term loans for cash flow purposes. The balance sheet forecast shows that the Authority does not expect the need to borrow in 2024/25.

5.2 **Objectives:** The Authority'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 the Authority's long-term plans change is a secondary objective.

5.3 **Strategy:** The Authority does not currently have any underlying need to borrow long-term to fund capital expenditure. The Mayoral Combined Authority holds no long-term loans and no long-term borrowing is anticipated during 2024/25. Therefore, a debt-free strategy will be maintained until such time as the Authority determines that its capital strategy and prioritised programme of investment requires consideration of any borrowing decision.

5.4 As part of its approach to liquidity management, the Authority may borrow short-term loans to cover any unplanned cash flow shortages as they arise. Rather than always keeping cash on instant access for unplanned cash flows, (where security and liquidity will mean yields will be low), the Authority will retain the option of short-term borrowing at low rates to enable it to explore increasing investments in longer-term and more diversified assets. The Authority will test access to borrowing occasionally even where this is not required to ensure liquidity is available.

5.5 **Sources of borrowing:** The approved sources of short-term borrowing are:

- Public Works Loan Board (PWLB) and any successor body
- UK Infrastructure Bank
- any institution approved for investments
- 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 Avon Pension Fund)

- capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

5.6 **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
- similar asset based finance

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

6. Treasury Management Prudential Indicators

6.1 The Authority measures and manages its exposures to treasury management risks using the following indicators.

6.2 **Security:** The Authority 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.

Credit risk indicator	Target
Minimum portfolio average credit rating	A-

6.3 **Liquidity:** The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount it can borrow each quarter without giving prior notice.

Liquidity risk indicator	Target
Total sum borrowed in past 3 months without prior notice	£40m

- 6.4 **Interest rate exposures:** This indicator is set to control the Authority’s exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interest rates will be:

Interest rate risk indicator	Limit
Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	£1.5m

The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at new market rates.

- 6.5 **Principal sums invested for periods longer than a year:** 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. The limits on the long-term principal sum invested to final maturities beyond the period end will be:

Price risk indicator	2024/25	2025/26	2026/27	+3 years
Limit on principal invested beyond 364 days as % of total cash balance	50%	30%	20%	20%

Long term investments 3 years plus include strategic pooled funds and real estate investment trusts with no fixed maturity.

7. Related Matters

The Chartered Institute of Public Finance and Accountancy Code requires the Authority to include the following in its treasury management strategy.

- 7.1 **Financial Derivatives:** 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. Lender Option Borrower Option loans and callable deposits). The general power of competence in section 113A of the Local Democracy, Economic Development and Construction Act 2009 removes much of the uncertainty over authorities’ use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

The Authority 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 the Authority 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, assessed using the appropriate credit rating for derivative exposures. An allowance for credit risk calculated using the methodology in the Treasury Management Practices document will count against the counterparty credit limit and the relevant foreign country limit.

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

- 7.2 Markets in Financial Instruments Directive (MiFID II):** As a result of the directive, Local Authorities will be treated as retail clients, but can opt up to professional client status, providing that they meet certain criteria which includes having an investment balance of at least £10m and the persons authorised to make investment decisions on behalf of the Mayoral Combined Authority having at least a year's relevant professional experience. In addition, the regulated financial services firms to whom this directive applies must assess that these persons have the expertise, experience and knowledge to make investment decisions and understand the risks involved.

The Authority has opted up to professional 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 the Authority's treasury management activities, the Chief Financial Officer believes this to be the most appropriate status.

8. Climate Change Implications

The Authority will continue to work with its Treasury Advisors Arlingclose for support and advice through its Environmental, Social and Governance (ESG) and responsible investment service.

9. Financial Implications

The budget for the West of England Mayoral Combined Authority investment income in 2024/25 is £11.7m million, based on an average investment portfolio of £300 million at an average interest rate of 4.25% and making an allowance for impairment as required.

Where investment income exceeds budget, e.g. from higher risk investments including pooled funds, then a recommendation will be made for 50% of the revenue savings to be transferred to a treasury management reserve to cover the risk of capital losses or lower interest rates payable in future years.

No immediate impact from the Chancellor's Autumn statement.

Advice given by: Selonge Russell, Head of Finance

10. Other Options Considered

10.1 The Chartered Institute of Public Finance and Accountancy Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Chief Financial Officer, having consulted the West of England Mayor and Chief Executive, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses may be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses may be smaller

Appendix A – Arlingclose Economic & Interest Rate Forecast – November 2023

Underlying assumptions:

- UK inflation and wage growth remain elevated but, following a no-change MPC decision in November, Bank Rate appears to have peaked in this rate cycle. Near-term rate cuts are unlikely, although downside risks will increase as the UK economy likely slides into recession and inflation falls more quickly
- The much-repeated message from the MPC is that monetary policy will remain tight as inflation is expected to moderate to target slowly. In the Bank's forecast, wage and services inflation, in particular, will keep CPI above the 2% target until 2026.
- The UK economy has so far been relatively resilient, but recent data indicates a further deceleration in business and household activity growth as higher interest rates start to bite. Global demand will remain soft, offering little assistance in offsetting weakening domestic demand. A recession remains a likely outcome.
- Employment demand is easing, although the tight labour market has resulted in higher nominal wage growth. Anecdotal evidence suggests slowing recruitment and pay growth, and we expect unemployment to rise further. As unemployment rises and interest rates remain high, consumer sentiment will deteriorate. Household spending will therefore be weak. Higher interest rates will also weigh on business investment and spending.
- Inflation will fall over the next 12 months. The path to the target will not be smooth, with higher energy prices and base effects interrupting the downtrend at times. The MPC's attention will remain on underlying inflation measures and wage data. We believe policy rates will remain at the peak for another 10 months, or until the MPC is comfortable the risk of further 'second-round' effects has diminished.
- Maintaining monetary policy in restrictive territory for so long, when the economy is already struggling, will require significant policy loosening in the future to boost activity.
- Global bond yields will remain volatile, particularly with the focus on US economic data and its monetary and fiscal policy. Like the BoE, the Federal Reserve and other central banks see persistently high policy rates through 2023 and 2024 as key to dampening domestic inflationary pressure. Bond markets will need to absorb significant new supply, particularly from the US government.
- There is a heightened risk of geo-political events causing substantial volatility in yields

Forecast:

- The MPC held Bank Rate at 5.25% in November. We believe this is the peak for Bank Rate.
- The MPC will cut rates in the medium term to stimulate the UK economy but will be reluctant to do so until it is sure there will be no lingering second-round effects. We see rate cuts from Q3 2024 to a low of around 3% by early-mid 2026.

- The immediate risks around Bank Rate remain on the upside, but these diminish over the next few quarters and shift to the downside before balancing out, due to the weakening UK economy and dampening effects on inflation.
- Arlingclose expects gilt yields to eventually fall from current levels (amid continued volatility) reflecting the lower medium-term path for Bank Rate. However, yields will remain relatively higher than in the past, due to quantitative tightening and significant bond.

	Current	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26	Sep-26
Official Bank Rate													
Upside risk	0.00	0.25	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00
Central Case	5.25	5.25	5.25	5.25	5.00	4.75	4.25	4.00	3.75	3.50	3.25	3.00	3.00
Downside risk	0.00	0.00	-0.25	-0.50	-0.75	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00
3-month money market rate													
Upside risk	0.00	0.25	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00
Central Case	5.40	5.40	5.40	5.30	5.15	4.80	4.30	4.10	3.80	3.50	3.25	3.05	3.05
Downside risk	0.00	0.00	-0.25	-0.50	-0.75	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00
5yr gilt yield													
Upside risk	0.00	0.50	0.70	0.70	0.85	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Central Case	4.28	4.35	4.30	4.25	4.10	4.00	3.75	3.50	3.40	3.30	3.30	3.30	3.35
Downside risk	0.00	-0.55	-0.75	-0.85	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00
10yr gilt yield													
Upside risk	0.00	0.50	0.70	0.70	0.80	0.90	1.00	1.10	1.20	1.20	1.20	1.20	1.20
Central Case	4.32	4.40	4.35	4.30	4.25	4.15	4.00	3.80	3.75	3.65	3.60	3.65	3.70
Downside risk	0.00	-0.55	-0.75	-0.85	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00
20yr gilt yield													
Upside risk	0.00	0.50	0.70	0.70	0.80	0.90	1.00	1.10	1.20	1.20	1.20	1.20	1.20
Central Case	4.78	4.70	4.65	4.55	4.45	4.35	4.25	4.25	4.25	4.25	4.25	4.25	4.25
Downside risk	0.00	-0.55	-0.75	-0.85	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00
50yr gilt yield													
Upside risk	0.00	0.50	0.70	0.70	0.80	0.90	1.00	1.10	1.20	1.20	1.20	1.20	1.20
Central Case	4.38	4.30	4.25	4.20	4.15	4.15	4.10	4.10	4.10	4.10	4.10	4.10	4.10
Downside risk	0.00	-0.55	-0.75	-0.85	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00

PWLB Standard Rate = Gilt yield + 1.00%

PWLB Certainty Rate = Gilt yield + 0.80%

PWLB HRA Rate = Gilt yield + 0.40%

UK Infrastructure Bank Rate = Gilt yield + 0.40%

Appendix B – Investment & Debt Portfolio Position

	31-Oct-23 Actual Portfolio £m	31-Oct-23 Average Rate %
Short-Term External borrowing:	5.0	4.00
Other long-term liabilities:	0	0
Total gross external debt	5.0	4.00
Treasury investments:		
Banks & building societies (unsecured)	10.2	1.49
Covered bonds & repo (secured)	0	0
Government (incl. local authorities)	291.0	4.00
Registered Providers	10.0	2.90
Money Market Funds	40.0	5.28
Social Housing Real Estate Investment Trust	5.00	2.85
Other pooled funds:		
CCLA Property Fund	10.0	3.87
Investec	10.0	4.04
Kames	10.0	6.20
Threadneedle	3.5	4.27
M & G	3.5	6.00
Royal London Enhanced Cash Plus Fund	10.0	5.28
Total treasury investments	403.2	4.16
Net investments	398.2	-

Appendix C – Treasury Management Monitoring

The Authority's investment position as at 31st October 2023 is detailed below in Table 1. This shows a balance held of £403m which is an increase from £355m at 31st March 2023.

As shown in the charts, the investment portfolio has been diversified across UK banks, Building Societies and Local Authorities. The Authority also uses AA rated Money Market Funds to maintain short term liquidity with £40m invested as at 31st October 2023. The Authority also retains units in pooled funds with £10m invested with the CCLA Property Fund, £10m with Investec, £10m with Kames, £10m with Royal London, £3.5m with Threadneedle, £3.5m with M&G, and £5m with Fundamentum as shown below in Table 2.

The forecast investment income to 31st March 2024 is £11m with an average rate of interest earned of circa 4%.

Investments are forecast to fall to £340m by the end of the 2023/24 financial year as capital grants are used to finance capital expenditure and project spend. Investments have been staggered, in terms of maturity dates, to ensure that there is a reasonable balance of available liquidity to finance required spend.

Table 1

The Authority's term of investments are as follows:	Balance as at 31st Oct 2023 £000s
Instant Access Funds	50,000
Pooled Including REIT	51,957
Up to 1 month	32,000
1 month to 3 months	36,189
4 months to 6 months	79,000
6 months to 12 months	135,000
More than 12 months	19,000
	403,146

Table 2: Pooled Funds

Fund Name	Asset Class	Purchase Value £000s	Fair Value as at 31/10/23 £000s	Capital Growth/(Loss) £000s	Income Return In Year
CCLA Property Fund	Property	9,956	8,925	-1,031	3.87%
Ninety One Diversified Income Fund (Investec)	Multi Asset	10,000	8,692	-1,308	4.04%
Aegon Diversified Monthly Income Fund (Kames)	Multi Asset	10,000	8,311	-1,689	6.20%
Threadneedle Strategic Bond Fund	Bond	3,500	2,931	-569	4.27%
M&G UK Income Distribution Fund	Equity - UK	3,500	3,371	-129	6.00%
Royal London Short Term Enhanced Cash Fund	Cash Plus	10,000	9,880	-120	3.60%
Fundamentum Social Housing REIT	Property	5,000	4,762	-238	2.74%
		51,956	46,872	-5,084	4.46%

The difficult current economic conditions continue to have a negative impact on our Pooled Funds. These investments are made in the knowledge that capital values will move both up and down on months and quarters, but with the confidence that over a three to five-year period, total returns will exceed interest rates. They provide regular revenue income and in 2023-24 will provide an average total return of 4.46%.

Chart 1 : West of England Mayoral Combined Authority Investments by Funding Source (£403.2m) at 31st October 2023

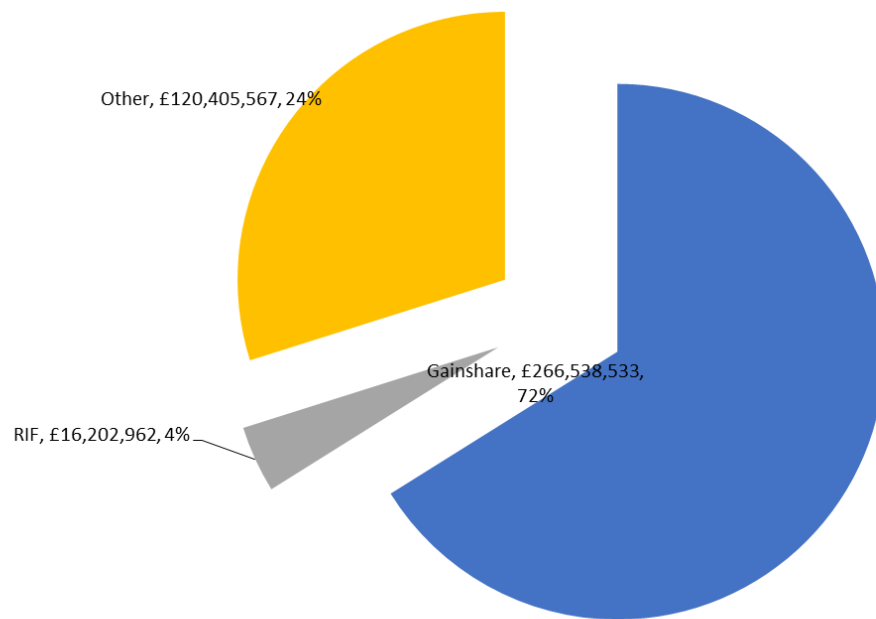


Chart 2: West of England Mayoral Combined Authority Investments per lowest equivalent Long Term credit rating (£403.2m) at 31st October 2023

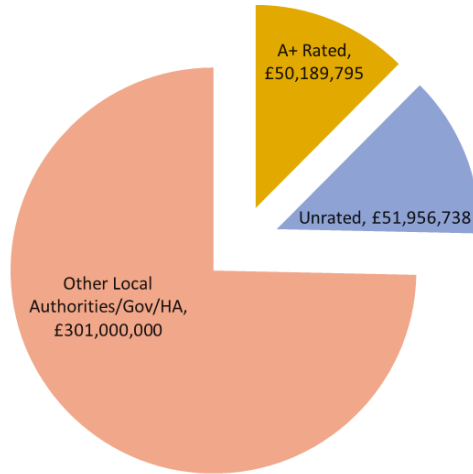
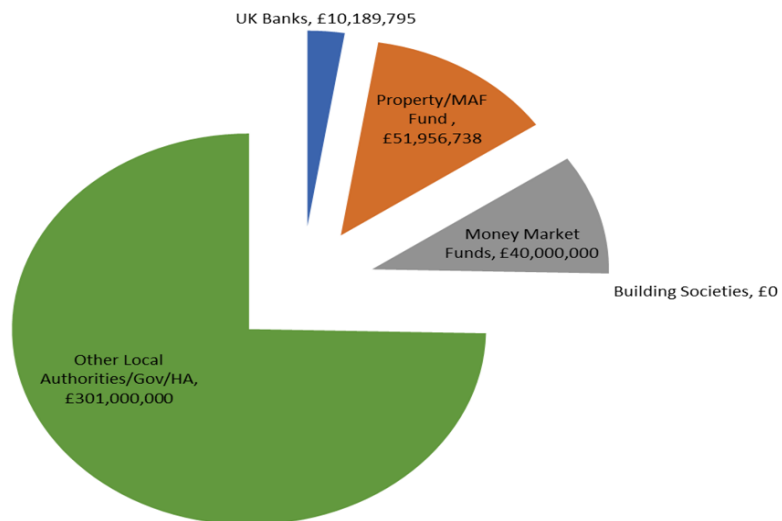


Chart 3: West of England Mayoral Combined Authority Investments by Type (£403.2m) as at 31st October 2023



Appendix D - Treasury Management Prudential Indicators

As required by the 2021 CIPFA Treasury Management Code, the Authority monitors and measures the below treasury management prudential indicators. The Authority's Prudential Indicators for 2023/24 were agreed by the Authority at its meeting on 27th January 2023 and performance against the key indicators is shown below.

Security: The Authority 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.

Credit risk indicator	Target	Actual
Minimum portfolio average credit rating	A-	A+

Liquidity: The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount it can borrow each quarter without giving prior notice.

Liquidity risk indicator	Target	Actual
Total sum borrowed in past 3 months without prior notice	£40m	£0

Interest rate exposures: This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% fall in interest rates will be:

Interest rate risk indicator	Limit	Actual
Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	£1m	£1.4m

The impact of a change in interest rates is calculated on the assumption that maturing investments will be replaced at new market rates. Due to the current high levels of investment balances, of which £147m matures within the next six months, this has resulted in the actual calculated impact exceeding the target.

Principal sums invested for periods longer than a year: 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. The limits on the long-term principal sum invested to final maturities beyond the period end will be:

Price risk indicator	2023/24 Target	2023/24 Actual	2024/25 Target	2024/25 Actual	2025/26 Target	2025/26 Actual	+3 Years Target	+3 Years Actual
Limit on principal invested beyond 364 days as % of total cash balance	50%	16%	30%	16%	20%	16%	20%	13%